14 10 2009 Wall Street's Naked Swindle ovvero Who kills Bear Stearns and Lehman Brothers

A scheme to flood the market with counterfeit stocks helped kill Bear Stearns and Lehman Brothers — and the feds have yet to bust the culprits

di MATT TAIBBI

On Tuesday, March 11th, 2008, somebody — nobody knows who — made one of the craziest bets Wall Street has ever seen. The mystery figure spent $1.7 million on a series of options, gambling that shares in the venerable investment bank Bear Stearns would lose more than half their value in nine days or less. It was madness — "like buying 1.7 million lottery tickets," according to one financial analyst.

But what's even crazier is that the bet paid.

At the close of business that afternoon, Bear Stearns was trading at $62.97. At that point, whoever made the gamble owned the right to sell huge bundles of Bear stock, at $30 and $25, on or before March 20th. In order for the bet to pay, Bear would have to fall harder and faster than any Wall Street brokerage in history.

The very next day, March 12th, Bear went into free fall. By the end of the week, the firm had lost virtually all of its cash and was clinging to promises of state aid; by the weekend, it was being knocked to its knees by the Fed and the Treasury, and forced at the barrel of a shotgun to sell itself to JPMorgan Chase (which had been given $29 billion in public money to marry its hunchbacked new bride) at the humiliating price of … $2 a share. Whoever bought those options on March 11th woke up on the morning of March 17th having made 159 times his money, or roughly $270 million. This trader was either the luckiest guy in the world, the smartest son of a bitch ever or…

Or what? That this was a brazen case of insider manipulation was so obvious that even Sen. Chris Dodd, chairman of the pillow-soft-touch Senate Banking Committee, couldn't help but remark on it a few weeks later, when questioning Christopher Cox, the then-chief of the Securities and Exchange Commission. "I would hope that you're looking at this," Dodd said. "This kind of spike must have triggered some sort of bells and whistles at the SEC. This goes beyond rumors."

Cox nodded sternly and promised, yes, he would look into it. What actually happened is another matter. Although the SEC issued more than 50 subpoenas to Wall Street firms, it has yet to identify the mysterious trader who somehow seemed to know in advance that one of the five largest investment banks in America was going to completely tank in a matter of days. "I've seen the SEC send agents overseas in a simple insider-trading case to investigate profits of maybe $2,000," says Brent Baker, a former senior counsel for the commission. "But they did nothing to stop this."

The SEC's halfhearted oversight didn't go unnoticed by the market. Six months after Bear was eaten by predators, virtually the same scenario repeated itself in the case of Lehman Brothers — another top-five investment bank that in September 2008 was vaporized in an obvious case of market manipulation. From there, the financial crisis was on, and the global economy went into full-blown crater mode.

Like all the great merchants of the bubble economy, Bear and Lehman were leveraged to the hilt and vulnerable to collapse. Many of the methods that outsiders used to knock them over were mostly legal: Credit markers were pulled, rumors were spread through the media, and legitimate short-sellers pressured the stock price down. But when Bear and Lehman made their final leap off the cliff of history, both undeniably got a push — especially in the form of a flat-out counterfeiting scheme called *naked short-selling*.

That this particular scam played such a prominent role in the demise of the two firms was supremely ironic. After all, the boom that had ballooned both companies to fantastic heights was basically a counterfeit economy, a mountain of paste that Wall Street had built to replace the legitimate business it no longer had. By the middle of the Bush years, the great investment banks like Bear and Lehman no longer made their money financing real businesses and creating jobs. Instead, Wall Street now serves, in the words of one former investment executive, as "Lucy to America's Charlie Brown," endlessly creating new products to lure the great herd of unwitting investors into whatever tawdry greed-bubble is being spun at the moment: Come kick the football again, only this time we'll call it the Internet, real estate, oil futures. Wall Street has turned the economy into a giant asset-stripping scheme, one whose purpose is to suck the last bits of meat from the carcass of the middle class.

What really happened to Bear and Lehman is that an economic drought temporarily left the hyenas without any more middle-class victims — and so they started eating each other, using the exact same schemes they had been using for years to fleece the rest of the country. And in the forensic footprint left by those kills, we can see for the first time exactly how the scam worked — and how completely even the government regulators who are supposed to protect us have given up trying to stop it.

This was a brokered bloodletting, one in which the power of the state was used to help effect a monstrous consolidation of financial and political power. Heading into 2008, there were five major investment banks in the United States: Bear, Lehman, Merrill Lynch, Morgan Stanley and Goldman Sachs. Today only Morgan Stanley and Goldman survive as independent firms, perched atop a restructured Wall Street hierarchy. And while the rest of the civilized world responded to last year's catastrophes with sweeping measures to rein in the corruption in their financial sectors, the United States invited the wolves into the government, with the popular new president, Barack Obama — elected amid promises to clean up the mess — filling his administration with Bear's and Lehman's conquerors, bestowing his papal blessing on a new era of robbery.

To the rest of the world, the brazenness of the theft — coupled with the conspicuousness of the government's inaction — clearly demonstrates that the American capital markets are a crime in progress. To those of us who actually live here, however, the news is even worse. We're in a place we haven't been since the Depression: Our economy is so completely fucked, the rich are running out of things to steal.

If you squint hard enough, you can see that the derivative-driven economy of the past decade has always, in a way, been about counterfeiting. At their most basic level, innovations like the ones that triggered the global collapse — credit-default swaps and collateralized debt obligations — were employed for the primary purpose of synthesizing out of thin air those revenue flows that our dying industrial economy was no longer pumping into the financial bloodstream. The basic concept in almost every case was the same: replacing hard assets with complex formulas that, once unwound, would prove to be backed by promises and IOUs instead of real stuff. Credit-default swaps enabled banks to lend more money without having the cash to cover potential defaults; one type of CDO let Wall Street issue mortgage-backed bonds that were backed not by actual monthly mortgage payments made by real human beings, but by the wild promises of other irresponsible lenders. They even called the thing a *synthetic* CDO — a derivative contract filled with derivative contracts — and nobody laughed. The whole economy was a fake.

For most of this decade, nobody rocked that fake economy — especially the faux housing market — better than Bear Stearns. In 2004, Bear had been one of five investment banks to ask the SEC for a relaxation of lending restrictions that required it to possess $1 for every $12 it lent out; as a result, Bear's debt-to-equity ratio soared to a staggering 33-1. The bank used much of that leverage to issue mountains of mortgage-backed securities, essentially borrowing its way to a booming mortgage business that helped drive its share price to a high of $172 in early 2007.

But that summer, Bear started to crater. Two of its hedge funds that were heavily invested in mortgage-backed deals imploded in June and July, forcing the credit-raters at Standard & Poor's to cut its outlook on Bear from stable to negative. The company survived through the winter — in part by jettisoning its dipshit CEO, Jimmy Cayne, a dithering, weed-smoking septuagenarian who was spotted at a bridge tournament during the crisis — but by March 2008, it was almost wholly dependent on a network of creditors who supplied it with billions in rolling daily loans to keep its doors open. If ever there was a major company ripe to be assassinated by market manipulators, it was Bear Stearns in 2008.

Then, on March 11th — around the same time that mystery Nostradamus was betting $1.7 million that Bear was about to collapse — a curious thing happened that attracted virtually no notice on Wall Street. On that day, a meeting was held at the Federal Reserve Bank of New York that was brokered by Fed chief Ben Bernanke and then-New York Fed president Timothy Geithner. The luncheon included virtually everyone who was anyone on Wall Street — except for Bear Stearns.

Bear, in fact, was the only major investment bank *not* represented at the meeting, whose list of participants reads like a Barzini-Tattaglia meeting of the Five Families. In attendance were Jamie Dimon from JPMorgan Chase, Lloyd Blankfein from Goldman Sachs, James Gorman from Morgan Stanley, Richard Fuld from Lehman Brothers and John Thain, the big-spending office redecorator still heading the not-yet-fully-destroyed Merrill Lynch. Also present were old Clinton hand Robert Rubin, who represented Citigroup; Stephen Schwarzman of the Blackstone Group; and several hedge-fund chiefs, including Kenneth Griffin of Citadel Investment Group.

The meeting was never announced publicly. In fact, it was discovered only by accident, when a reporter from Bloomberg filed a request under the Freedom of Information Act and came across a mention of it in Bernanke's schedule. *Rolling Stone* has since contacted every major attendee, and all declined to comment on what was discussed at the meeting. "The ground rules of the lunch were of confidentiality," says a spokesman for Morgan Stanley. "Blackstone has no comment," says a spokesman for Schwarzman. Rubin declined a request for an interview, Fuld's people didn't return calls, and Goldman refused to talk about the closed-door session. The New York Fed said the meeting, which had been scheduled weeks earlier, was simply business as usual: "Such informal, small group sessions can provide a valuable means to learn about market functioning from people with firsthand knowledge."

So what did happen at that meeting? There's no evidence that Bernanke and Geithner called the confidential session to discuss Bear's troubles, let alone how to carve up the bank's spoils. It's possible that one of them made an impolitic comment about Bear during a meeting held for other reasons, inadvertently fueling a run on the bank. What's impossible to believe is the bullshit version that Geithner and Bernanke later told Congress. The month after Bear's collapse, both men testified before the Senate that they only learned how dire the firm's liquidity problems were on Thursday, March 13th — despite the fact that rumors of Bear's troubles had begun as early as that Monday and both men had met in person with every key player on Wall Street that Tuesday. This is a little like saying you spent the afternoon of September 12th, 2001, in the Oval Office, but didn't hear about the Twin Towers falling until September 14th.

Given the Fed's cloak of confidentiality, we simply don't know what happened at the meeting. But what we do know is that from the moment it ended, the run on Bear was on, and every major player on Wall Street with ties to Bear started pulling IV tubes out of the patient's arm. Banks, brokers and hedge funds that held cash in Bear's accounts yanked it out in mass quantities (making it harder for the firm to meet its credit payments) and took out credit-default swaps against Bear (making public bets that the firm was going to tank). At the same time, Bear was blindsided by an avalanche of "novation requests" — efforts by worried creditors to sell off the debts that Bear owed them to other Wall Street firms, who would then be responsible for collecting the money. By the afternoon of March 11th, two rival investment firms — Credit Suisse and Goldman Sachs — were so swamped by novation requests for Bear's debt that they temporarily stopped accepting them, signaling the market that they had grave doubts about Bear.

All of these tactics were elements that had often been seen in a kind of scam known as a "bear raid" that small-scale stock manipulators had been using against smaller companies for years. But the most damning thing the attack on Bear had in common with these earlier manipulations was the employment of a type of counterfeiting scheme called naked short-selling. From the moment the confidential meeting at the Fed ended on March 11th, Bear became the target of this ostensibly illegal practice — and the companies widely rumored to be behind the assault were in that room. Given that the SEC has failed to identify who was behind the raid, Wall Street insiders were left with nothing to trade but gossip. According to the former head of Bear's mortgage business, Tom Marano, the rumors within Bear itself that week centered around Citadel and Goldman. Both firms were later subpoenaed by the SEC as part of its investigation into market manipulation — and the CEOs of both Bear and Lehman were so suspicious that they reportedly contacted Blankfein to ask whether his firm was involved in the scam. (A Goldman spokesman denied any wrongdoing, telling reporters it was "rigorous about conducting business as usual.")

The roots of short-selling date back to 1973, when Wall Street went to a virtually paperless system for trading stocks. Before then, if you wanted to sell shares you owned in Awesome Company X, you and the buyer would verbally agree to the deal through a broker. The buyer would take legal ownership of the shares, but only later would the broker deliver the actual, physical shares to the buyer, using an absurd, *Brazil*-style network of runners who carried paper shares from one place to another — a preposterous system that threatened to cripple trading altogether.

To deal with the problem, Wall Street established a kind of giant financial septic tank called the Depository Trust Company. Privately owned by a consortium of brokers and banks, the DTC centralizes and maintains all records of stock transactions. Now, instead of being schlepped back and forth across Manhattan by messengers on bikes, almost all physical shares of stock remain permanently at the DTC. When one broker sells shares to another, the trust company "delivers" the shares simply by making a change in its records.

This new electronic system spurred an explosion of financial innovation. One practice that had been little used before but now began to be employed with great popularity was short- selling, a perfectly legal type of transaction that allows investors to bet against a stock. The basic premise of a normal short sale is easy to follow. Say you're a hedge-fund manager, and you want to bet against the stock of a company — let's call it Wounded Gazelle International (WGI). What you do is go out on the market and find someone — often a brokerage house like Goldman Sachs — who has shares in that stock and is willing to lend you some. So you go to Goldman on a Monday morning, and you borrow 1,000 shares in Wounded Gazelle, which that day happens to be trading at $10.

Now you take those 1,000 borrowed shares, and you sell them on the open market at $10, which leaves you with $10,000 in cash. You then take that $10,000, and you wait. A week later, surveillance tapes of Wounded's CEO having sex with a woodchuck in a Burger King bathroom appear on CNBC. Awash in scandal, the firm's share price tumbles to 3½. So you go out on the market and buy back those 1,000 shares of WGI — only now it costs you only $3,500 to do so. You then return the shares to Goldman Sachs, at which point your interest in WGI ends. By betting against or "shorting" the company, you've made a profit of $6,500.

It's important to point out that not only is normal short-selling completely legal, it can also be socially beneficial. By incentivizing Wall Street players to sniff out inefficient or corrupt companies and bet against them, short-selling acts as a sort of policing system; legal short-sellers have been instrumental in helping expose firms like Enron and WorldCom. The problem is, the new paperless system instituted by the DTC opened up a giant loophole for those eager to game the market. Under the old system, would-be short-sellers had to physically borrow actual paper shares before they could execute a short sale. In other words, you had to actually have stock before you could sell it. But under the new system, a short-seller only had to make a good-faith effort to "locate" the stock he wanted to borrow, which usually amounts to little more than a conversation with a broker:

Evil Hedge Fund: I want to short IBM. Do you have a million shares I can borrow?

Corrupt Broker [*not checking, playing Tetris*]: Uh, yeah, whatever. Go ahead and sell.

There was nothing to prevent that broker — let's say he has only a million shares of IBM total — from making the same promise to five different hedge funds. And not only could brokers lend stocks they never had, another loophole in the system allowed hedge funds to sell those stocks and deliver a kind of IOU instead of the actual share to the buyer. When a share of stock is sold but never delivered, it's called a "fail" or a "fail to deliver" — and there was no law or regulation in place that prevented it. It's exactly what it sounds like: a loophole legalizing the counterfeiting of stock. In place of real stock, the system could become infected with "fails" — phantom IOU shares — instead of real assets.

If you own stock that pays a dividend, you can even look at your dividend check to see if your shares are real. If you see a line that says "PIL" — meaning "Payment in Lieu" of dividends — your shares were never actually delivered to you when you bought the stock. The mere fact that you're even getting this money is evidence of the crime: This counterfeiting scheme is so profitable for the hedge funds, banks and brokers involved that they are willing to pay "dividends" for shares that do not exist. "They're making the payments without complaint," says Susanne Trimbath, an economist who worked at the Depository Trust Company. "So they're making the money somewhere else."

Trimbath was one of the first people to notice the problem. In 1993, she was approached by a group of corporate transfer agents who had a complaint. Transfer agents are the people who keep track of who owns shares in corporations, for the purposes of voting in corporate elections. "What the transfer agents saw, when corporate votes came up, was that they were getting more votes than there were shares," says Trimbath. In other words, transfer agents representing a corporation that had, say, 1 million shares outstanding would report a vote on new board members in which 1.3 million votes were cast — a seeming impossibility.

Analyzing the problem, Trimbath came to an ugly conclusion: The fact that short-sellers do not have to deliver their shares made it possible for two people at once to think they own a stock. Evil Hedge Fund X borrows 100 shares from Unwitting Schmuck A, and sells them to Unwitting Schmuck B, who never actually receives that stock: In this scenario, both Schmucks will appear to have full voting rights. "There's no accounting for share ownership around short sales," Trimbath says. "And because of that, there are multiple owners assigned to one share."

Trimbath's observation would prove prophetic. In 2005, a trade group called the Securities Transfer Association analyzed 341 shareholder votes taken that year — and found evidence of over-voting in *every single one*. Experts in the field complain that the system makes corporate-election fraud a comically simple thing to achieve: In a process known as "empty voting," anyone can influence any corporate election simply by borrowing great masses of shares shortly before an important merger or board election, exercising their voting rights, then returning the shares right after the vote is over. Hilariously, because you're only borrowing the shares and not buying them, you can effectively "buy" a corporate election for free.

Back in 1993, over-voting might have seemed a mere curiosity, the result not of fraud but of innocent bookkeeping errors. But Trimbath realized the broader implication: Just as the lack of hard rules forcing short-sellers to deliver shares makes it possible for unscrupulous traders to manipulate a corporate vote, it could also enable them to manipulate the price of a stock by selling large quantities of shares they didn't possess. She warned her bosses that this crack in the system made the specter of organized counterfeiting a real possibility.

"I personally went to senior management at DTC in 1993 and presented them with this issue," she recalls. "And their attitude was, 'We spill more than that.'" In other words, the problem represented such a small percentage of the assets handled annually by the DTC — as much as $1.8 quadrillion in any given year, roughly 30 times the GDP of the entire planet — that it wasn't worth worrying about.

It wasn't until 10 years later, when Trimbath had a chance meeting with a lawyer representing a company that had been battered by short-sellers, that she realized someone outside the DTC had seized control of a financial weapon of mass destruction. "It was like someone figured out how to aim and fire the Death Star in *Star Wars*," she says. What they "figured out," Trimbath realized, was an early version of the naked-shorting scam that would help take down Bear and Lehman.

Here's how naked short-selling works: Imagine you travel to a small foreign island on vacation. Instead of going to an exchange office in your hotel to turn your dollars into Island Rubles, the country instead gives you a small printing press and makes you a deal: Print as many Island Rubles as you like, then on the way out of the country you can settle your account. So you take your printing press, print out gigantic quantities of Rubles and start buying goods and services. Before long, the cash you've churned out floods the market, and the currency's value plummets. Do this long enough and you'll crack the currency entirely; the loaf of bread that cost the equivalent of one American dollar the day you arrived now costs less than a cent.

With prices completely depressed, you keep printing money and buy everything of value — homes, cars, priceless works of art. You then load it all into a cargo ship and head home. On the way out of the country, you have to settle your account with the currency office. But the Island Rubles you printed are now worthless, so it takes just a handful of U.S. dollars to settle your debt. Arriving home with your cargo ship, you sell all the island riches you bought at a discount and make a fortune.

This is the basic outline for how to seize the assets of a publicly traded company using counterfeit stock. What naked short-sellers do is sell large quantities of stock they don't actually have, flooding the market with "phantom" shares that, just like those Island Rubles, depress a company's share price by making the shares less scarce and therefore less valuable.

The first documented cases of this scam involved small-time boiler-room grifters. In the late 1990s, not long after Trimbath warned her bosses about the problem, a trader named John

Fiero executed a series of "bear raids" on small companies. First he sold shares he didn't possess in huge quantities and fomented negative rumors about a company; then, in a classic shakedown, he approached the firm with offers to desist — if they'd sell him stock at a discount. "He would press a button and enter a trade for half a million shares," says Brent Baker, the SEC official who busted Fiero. "He didn't have the stock to cover that — but the price of the stock would drop to a penny."

In 2005, complaints from investors about naked short-selling finally prompted the SEC to try to curb the scam. A new rule called Regulation SHO, known as "Reg SHO" for short, established a series of guidelines designed, in theory, to prevent traders from selling stock and then failing to deliver it to the buyer. "Intentionally failing to deliver stock," then-SEC chief Christopher Cox noted, "is market manipulation that is clearly violative of the federal securities laws." But thanks to lobbying by hedge funds and brokers, the new rule included no financial penalties for violators and no real enforcement mechanism. Instead, it merely created a thing called the "threshold list," requiring short-sellers to close out their positions in any company where the amount of "fails to deliver" exceeded 10,000 shares for more than 13 days. In other words, if counterfeiters got caught selling a chunk of phantom shares in a firm for two straight weeks, they were no longer allowed to counterfeit the stock.

A nice, if timid idea — except that it's completely meaningless. Not only has there been virtually no enforcement of the rule, but the SEC doesn't even bother to track who is targeting companies with failed trades. As a result, many stocks attacked by naked short-sellers spent years on the threshold list, including Krispy Kreme, Martha Stewart and Overstock.com.

"We were actually on it for 668 consecutive days," says Patrick Byrne, the CEO of Overstock, who became a much-ridiculed pariah on Wall Street for his lobbying against naked short-selling. At one point, investors claimed ownership of nearly 42 million shares in Overstock — even though fewer than 24 million shares in the company had actually been issued.

Byrne is not an easy person for anyone with any kind of achievement neuroses to like. He is young, good-looking, has shitloads of money, speaks fluent Chinese, holds a doctorate in philosophy and spent his youth playing hooky from high school and getting business tips from the likes of Warren Buffett. But because of his fight against naked short-selling, he has been turbofragged by the mainstream media as a tinfoil-hat lunatic; one story in the *New York Post* featured a picture of Byrne with a flying saucer coming out of his head.

Nonetheless, Byrne's howlings about naked short-selling look extremely prescient in light of what happened to Bear and Lehman. Over the past four years, Byrne has outlined the parameters of a naked-shorting scam that always includes some combination of the following elements: negative rumors planted in the financial press, the flooding of the market with enormous quantities of undelivered shares, absurdly high trading volumes and the prolonged appearance of the targeted company on the Reg SHO list.

In January 2005 — at the exact moment Reg SHO was launched — Byrne's own company was trading above $65 a share, and the number of failed trades in circulation was virtually nil. By March 2006, however, Overstock was down to $28 a share, and Reg SHO data indicated an explosion of failed trades — nearly 4 million undelivered shares on some days. At those moments, in other words, nearly a fifth of all Overstock shares were fake.

"This really isn't about my company," Byrne says. "I mean, I've made my money. My initial concern, of course, was with Overstock. But the more I learned about this, the more my real worry became 'Jesus, what are the implications for the system?' And given what happened to Bear and Lehman last year, I think we ended up seeing what some of those implications are."

Bear Stearns wasn't the kind of company that had a problem with naked short-selling. Before

March 11th, 2008, there had never been a period in which significant quantities of Bear stock had been sold and then not delivered, and the company had never shown up on the Reg SHO list. But beginning on March 12th — the day after the Fed meeting that failed to include Bear, and the mysterious purchase of the options betting on the firm's imminent collapse — the number of counterfeit shares in Bear skyrocketed.

The best way to grasp what happened is to look at the data: On Tuesday, March 11th, there were 201,768 shares of Bear that had failed to deliver. The very next day, the number of phantom shares leaped to 1.2 million. By the close of trading that Friday, the number passed 2 million — and when the market reopened the following Monday, it soared to 13.7 million. In less than a week, the number of counterfeit shares in Bear had jumped nearly seventyfold.

The giant numbers of undelivered shares over the course of that week amounted to one of the most blatant cases of stock manipulation in Wall Street history. "There is not a doubt in my mind, not a single doubt" that naked short-selling helped destroy Bear, says Sen. Ted Kaufman, a Democrat from Delaware who has introduced legislation to curb such financial fraud. Asked to rate how obvious a case of naked short-selling Bear is, on a scale of one to 10, former SEC counsel Brent Baker doesn't hesitate. "Easily a 10," he says.

At the same time that naked short- sellers were counterfeiting Bear's stock, the firm was being hit by another classic tactic of bear raids: negative rumors in the media. Tipped off by a source, CNBC reporter David Faber reported on March 12th that Goldman Sachs had held up a trade with Bear because it was worried about the firm's creditworthiness. Faber noted that the hold was temporary — the deal had gone through that morning. But the damage was done; inside Bear, Faber's report was blamed for much of the subsequent panic.

"I like Faber, he's a good guy," a Bear executive later said. "But I wonder if he ever asked himself, 'Why is someone telling me this?' There was a reason this was leaked, and the reason is simple: Someone wanted us to go down, and go down hard."

At first, the full-blown speculative attack on Bear seemed to be working. Thanks to the media-fueled rumors and the mounting anxiety over the company's ability to make its payments, Bear's share price plummeted seven percent on March 13th, to $57. It still had a ways to go for the mysterious short-seller to make a profit on his bet against the firm, but it was headed in the right direction. But then, early on the morning of Friday, March 14th, Bear's CEO, Alan Schwartz, struck a deal with the Fed and JPMorgan to provide an emergency loan to keep the company's doors open. When the news hit the street that morning, Bear's stock rallied, gaining more than nine percent and climbing back to $62.

The sudden and unexpected rally prompted celebrations inside Bear's offices. "We're alive!" someone on the company's trading floor reportedly shouted, and employees greeted the news by high-fiving each other. Many gleefully believed that the short-sellers targeting the firm would get "squeezed" — in other words, if the share price kept going up, the bets against Bear would blow up in the attackers' faces.

The rally proved short-lived — Bear ended the day at $30 — but it suggested that all was not lost. Then a strange thing happened. As Bear understood it, the emergency credit line that the Fed had arranged was originally supposed to last for 28 days. But that Friday, despite the rally, Geithner and then-Treasury secretary Hank Paulson — the former head of Goldman Sachs, one of the firms rumored to be shorting Bear — had a sudden change of heart. When the market closed for the weekend, Paulson called Schwartz and told him that the rescue timeline had to be accelerated. Paulson wouldn't stay up another night worrying about Bear Stearns, he reportedly told Schwartz. Bear had until Sunday night to find a buyer or it could go fuck itself.

Bear was out of options. Over the course of that weekend, the firm opened its books to

JPMorgan, the only realistic potential buyer. But upon seeing all the "shit" on Bear's books, as one source privy to the negotiations put it — including great gobs of toxic investments in the subprime markets — JPMorgan hedged. It wouldn't do the deal, it announced, unless it got two things: a huge bargain on the sale price, and a lot of public money to wipe out the "shit."

So the Fed — on whose New York board sits JPMorgan chief Jamie Dimon — immediately agreed to accommodate the new buyers, forking over $29 billion in public funds to buy up the yucky parts of Bear. Paulson, meanwhile, took care of the bargain issue, putting the government's gun to Schwartz's head and telling him he had to sell low. *Really* low.

On Saturday night, March 15th, Schwartz and Dimon had discussed a deal for JPMorgan to buy Bear at $8 to $12 a share. By Sunday afternoon, however, Geithner reported that the price had plunged even further. "Shareholders are going to get between $3 and $5 a share," he told Paulson.

But Paulson pissed on even that price from a great height. "I can't see why they're getting anything," he told Dimon that afternoon from Washington, via speakerphone. "I could see something nominal, like $1 or $2 per share."

Just like that, with a slight nod of Paulson's big shiny head, Bear was vaporized. This, remember, all took place while Bear's stock was still selling at $30. By knocking the share price down 28 bucks, Paulson ensured that the manipulators who were illegally counterfeiting Bear's shares would make an awesome fortune.

Although we don't know who was behind the naked short-selling that targeted Bear — short-traders aren't required to reveal their stake in a company — the scam wasn't just a fetish crime for small-time financial swindlers. On the contrary, the widespread selling of shares without delivering them translated into an enormously profitable business for the biggest companies on Wall Street, fueling the growth of a booming sector in the financial-services industry called Prime Brokerage.

As with other Wall Street abuses, the lucrative business in counterfeiting stock got its start with a semisecret surrender of regulatory authority by the government. In 1989, a group of prominent Wall Street broker-dealers — led, ironically, by Bear Stearns — asked the SEC for permission to manage the accounts of hedge funds engaged in short-selling, assuming responsibility for locating, lending and transferring shares of stock. In 1994, federal regulators agreed, allowing the nation's biggest investment banks to serve as Prime Brokers. Think of them as the house in a casino: They provide a gambler with markers to play and to manage his winnings.

Under the original concept, a hedge fund that wanted to short a stock like Bear Stearns would first "locate" the stock with his Prime Broker, then would do the trade with a so-called Executing Broker. But as time passed, Prime Brokers increasingly allowed their hedge-fund customers to use automated systems and "locate" the stock themselves. Now the conversation went something like this:

Evil Hedge Fund: I just sold a million shares of Bear Stearns. Here, hold this shitload of money for me.

Prime Broker: Awesome! Where did you borrow the shares from?

Evil Hedge Fund: Oh, from Corrupt Broker. You know, Vinnie.

Prime Broker: Oh, OK. Is he sure he can find those shares? Because, you know, there are rules.

Evil Hedge Fund: Oh, yeah. You know Vinnie. He's good for it.

Prime Broker: Sweet!

Following the SEC's approval of this cozy relationship, Prime Brokers boomed. Indeed, with the rise of discount brokers online and the collapse of IPOs and corporate mergers, Prime Brokerage — in essence, the service end of the short- selling business — is now one of the most profitable sectors that big Wall Street firms have left. Last year, Goldman Sachs netted $3.4 billion providing "securities services" — the lion's share of it from Prime Brokerage.

When one considers how easy it is for short-sellers to sell stock without delivering, it's not hard to see how this can be such a profitable business for Prime Brokers. It's really a license to print money, almost in the literal sense. As such, Prime Brokers have tended to be lax about making sure that their customers actually possess, or can even realistically find, the stock they've sold. That point is made abundantly clear by tapes obtained by *Rolling Stone* of recent meetings held by the compliance officers for big Prime Brokers like Goldman Sachs, Morgan Stanley and Deutsche Bank. Compliance officers are supposed to make sure that traders at their firms follow the rules — but in the tapes, they talk about how they routinely greenlight transactions they know are dicey.

In a conference held at the JW Marriott Desert Ridge Resort in Phoenix in May 2008 — just over a month after Bear collapsed — a compliance officer for Goldman Sachs named Jonathan Breckenridge talks with his colleagues about how the firm's customers use an automated program to report where they borrowed their stock from. The problem, he says, is the system allows short-sellers to enter anything they want in the text field, no matter how nonsensical — or even leave the field blank. "You can enter *ABC*, you can enter *Go*, you can enter *Locate Goldman*, you can enter whatever you want," he says. "Three dots — I've actually seen that."

The room erupts with laughter.

After making this admission, Breckenridge asks officials from the Securities Industry and Financial Markets Association, the trade group representing Wall Street broker-dealers, for guidance in how to make this appear less blatantly improper. "How do you have in place a process," he wonders, "and make sure that it looks legit?"

The funny thing is that Prime Brokers didn't even need to fudge the rules. They could counterfeit stocks legally, thanks to yet another loophole — this one involving key players known as "market makers." When a customer wants to buy options and no one is lining up to sell them, the market maker steps in and sells those options out of his own portfolio. In market terms, he "provides liquidity," making sure you can always buy or sell the options you want.

Under what became known as the "options market maker exception," the SEC permitted a market maker to sell shares whether or not he had them or could find them right away. In theory, this made sense, since delaying the market maker from selling to offset a big buy order could dry up liquidity and slow down trading. But it also created a loophole for naked short-sellers to kill stocks easily — and legally. Take Bear Stearns, for example. Say the stock is trading at $62, as it was on March 11th, and someone buys put options from the market maker to sell $1.7 million in Bear stock nine days later at $30. To offset that big trade, the market maker might try to keep his own portfolio balanced by selling off shares in the company, whether or not he can locate them.

But here's the catch: The market maker often sells those phantom shares to the same person who bought the put options. That buyer, after all, would love to snap up a bunch of counterfeit Bear stock, since he can drive the company's price down by reselling those fake shares. In fact, the shares you buy from a market maker via the SEC-sanctioned loophole are sometimes called "bullets," because when you pump these counterfeit IOUs into the market, it's like firing bullets into the company — it kills the price, just like printing more Island Rubles kills a currency.

Which, it appears, is exactly what happened to Bear Stearns. Someone bought a shitload of puts in Bear, and then someone sold a shitload of Bear shares that never got delivered. Bear then staggered forward, bleeding from every internal organ, and fell on its face. "It looks to me like Bear Stearns got riddled with bullets," John Welborn, an economist with an investment firm called the Haverford Group, later observed.

So who conducted the naked short- selling against Bear? We don't know — but we do know that, thanks to the free pass the SEC gave them, Prime Brokers stood to profit from the transactions. And the confidential meeting at the Fed on March 11th included all the major Prime Brokers on Wall Street — as well as many of the biggest hedge funds, who also happen to be some of the biggest short-sellers on Wall Street.

The economy's financial woes might have ended there — leaving behind an unsolved murder in which many of the prime suspects profited handsomely. But three months later, the killers struck again. On June 27th, 2008, an avalanche of undelivered shares in Lehman Brothers started piling up in the market. June 27th: 705,103 fails. June 30th: 814,870 fails. July 1st: 1,556,301 fails.

Then the rumors started. A story circulated on June 30th about Barclays buying Lehman for 25 percent less than the share price. The tale was quickly debunked, but the attacks continued, with hundreds of thousands of failed trades every day for more than a week — during which time Lehman lost 44 percent of its share price. The major players on Wall Street, who for years had confined this unseemly sort of insider rape to smaller companies, had begun to eat each other alive.

It made great capitalist sense to attack these giant firms — they were easy targets, after all, hideously mismanaged and engorged with debt — but an all-out shooting war of this magnitude posed a risk to everyone. And so a cease-fire was declared. In a remarkable order issued on July 15th, Cox dictated that short-sellers must actually pre-borrow shares before they sell them. But in a hilarious catch, the order only covered shares of the 19 biggest firms on Wall Street, including Morgan Stanley and Goldman Sachs, and would last only a month.

This was one of the most amazing regulatory actions ever: It essentially told Wall Street that it was enjoined from counterfeiting stock — but only temporarily, and only the stock of the 19 of the richest companies on Wall Street. Not surprisingly, the share price for Lehman and some of the other lucky robber barons surged on the news.

But the relief was short-lived. On August 12th, 2008, the Cox order expired — and fails in Lehman stock quickly started mounting. The attack spiked on September 9th, when there were over 1 million undelivered shares in Lehman. On September 10th, there were 5,877,649 failed trades. The day after, there were an astonishing 22,625,385 fails. The next day: 32,877,794. Then, on September 15th, the price of Lehman Brothers stock fell to 21 cents, and the company declared bankruptcy.

That naked shorting was the tool used to kill the company — which was, like Bear, a giant bursting sausage of deadly subprime deals that didn't need much of a push off the cliff — was obvious to everyone. Lehman CEO Richard Fuld, admittedly one of the biggest assholes of the 21st century, said as much a month later. "The naked shorts and rumormongers succeeded in bringing down Bear Stearns," Fuld told Congress. "And I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers."

The methods used to destroy these companies pointed to widespread and extravagant market manipulation, and the death of Lehman should have instigated a full-bore investigation. "This isn't a trail of bread crumbs," former SEC enforcement director Irving Pollack has pointed out. "This audit trail is lit up like an airport runway. You can see it a mile off. Subpoena e-mails. Find out who spread false rumors and also shorted the stock, and you've got your manipulators."

It would be an easy matter for the SEC to determine who killed Bear and Lehman, if it wanted to — all it has to do is look at the trading data maintained by the stock exchanges. But 18 months after the widespread market manipulation, the federal government's cop on the financial beat has barely lifted a finger to solve the two biggest murders in Wall Street history. The SEC refuses to comment on what, if anything, it is doing to identify the wrongdoers, saying only that "investigations related to the financial crisis are a priority."

The commission did repeal the preposterous "market maker" loophole on September 18th, 2008, forbidding market makers from selling phantom shares. But that same day, the SEC also introduced a comical agreement called "Rule 10b-21," which makes it illegal for an Evil Hedge Fund to lie to a Prime Broker about where he borrowed his stock. Basically, this new rule formally exempted Wall Street's biggest players from any blame for naked short-selling, putting it all on the backs of their short-seller clients. Which was good news for firms like Goldman Sachs, which only a year earlier had been fined $2 million for repeatedly turning a blind eye to clients engaged in illegal short-selling. Instead of tracking down the murderers of Bear and Lehman, the SEC simply eliminated the law against aiding and abetting murder. "The new rule just exempted the Prime Brokers from legal responsibility," says a financial player who attended closed-door discussions about the regulation. "It's a joke."

But the SEC didn't stop there — it also went out of its way to protect the survivors from the normal functioning of the marketplace. On September 15th, the same day that Lehman declared bankruptcy, the share price of Goldman and Morgan Stanley began to plummet sharply. There was little evidence of phantom shares being sold — in Goldman's case, fewer than .02 percent of all trades failed. Whoever was attacking Goldman and Morgan Stanley — if anyone was — was for the most part doing it legally, through legitimate short-selling. As a result, when the SEC imposed yet another order on September 17th curbing naked short-selling, it did nothing to help either firm, whose share prices failed to recover.

Then something extraordinary happened. Morgan Stanley lobbied the SEC for a ban on *legitimate* short-selling of financial stocks — a thing not even the most ardent crusaders against naked short- selling, not even tinfoil-hat-wearing Patrick Byrne, had ever favored. "I spent years just trying to get the SEC to listen to a request that they stop people from rampant illegal counterfeiting of my company's stock," says Byrne. "But when Morgan Stanley asks for a ban on legal short-selling, they get it literally overnight."

Indeed, on September 19th, Cox imposed a temporary ban on legitimate short- selling of all financial stocks. The stock price of both Goldman and Morgan Stanley quickly rebounded. The companies were also bailed out by an instant designation as bank holding companies, which made them eligible for a boatload of emergency federal aid. The law required a five-day wait for such a conversion, but Geithner and the Fed granted Goldman and Morgan Stanley their new status overnight.

So who killed Bear Stearns and Lehman Brothers? Without a bust by the SEC, all that's left is means and motive. Everyone in Washington and on Wall Street understood what it meant when Lehman, for years the hated rival of Goldman Sachs, was chosen by Treasury Secretary Hank Paulson — the former Goldman CEO — to be the one firm that *didn't* get a federal bailout. "When Paulson, a former Goldman guy, chose to sacrifice Lehman, that's when you knew the whole fucking thing was dirty," says one Democratic Party operative. "That's like the Yankees not bailing out the Mets. It was just obvious."

The day of Lehman's collapse, Paulson also bullied Bank of America into buying Merrill Lynch — which left Goldman Sachs and Morgan Stanley as the only broker-teens left unaxed in the Camp Crystal Lake known as the American economy. Before they were hacked to bits, Merrill, Bear and Lehman all nurtured booming businesses as Prime Brokers. All that lucrative work had to go somewhere. So guess which firms made the most money in Prime Brokerage this year? According to a leading industry source, the top three were Goldman, JPMorgan and Morgan Stanley.

We may never know who killed Bear and Lehman. But it sure isn't hard to figure out who's left.

While naked short-selling was the weapon used to bring down both Bear and Lehman, it would be preposterous to argue that the practice caused the financial crisis. The most serious problems in this economy were the result of other, broader classes of financial misdeed: corruption of the ratings agencies, the use of smoke-and-mirrors like derivatives, an epidemic tulipomania called the housing boom and the overall decline of American industry, which pushed Wall Street to synthesize growth where none existed.

But the "phantom" shares produced by naked short-sellers are symptomatic of a problem that goes far beyond the stock market. "The only reason people talk about naked shorting so much is that stock is sexy and so much attention is paid to the stock market," says a former investment executive. "This goes on in all the markets."

Take the commodities markets, where most of those betting on the prices of things like oil, wheat and soybeans have no product to actually deliver. "All speculative selling of commodity futures is 'naked' short selling," says Adam White, director of research at White Knight Research and Trading. While buying things that don't actually exist isn't always harmful, it can help fuel speculative manias, like the oil bubble of last summer. "The world consumes 85 million barrels of oil per day, but it's not uncommon to trade 1 billion barrels per day on the various commodities exchanges," says White. "So you've got 12 paper barrels trading for every physical barrel."

The same is true for mortgages. When lenders couldn't find enough dope addicts to lend mansions to, some simply went ahead and started selling the same mortgages over and over to different investors. There are now a growing number of cases of such double-selling of mortgages: "It makes Bernie Madoff seem like chump change," says April Charney, a legal-aid attorney based in Florida. Just like in the stock market, where short-sellers delivered IOUs instead of real shares, traders of mortgage-backed securities sometimes conclude deals by transferring "lost-note affidavits" — basically a "my dog ate the mortgage" note — instead of the actual mortgage. A paper presented at the American Bankruptcy Institute earlier this year reports that up to a third of all notes for mortgage-backed securities may have been "misplaced or lost" — meaning they're backed by IOUs instead of actual mortgages.

How about bonds? "Naked short-selling of stocks is nothing compared to what goes on in the bond market," says Trimbath, the former DTC staffer. Indeed, the practice of selling bonds without delivering them is so rampant it has even infected the market for U.S. Treasury notes. That's right — Wall Street has actually been brazen enough to counterfeit the debt of the United States government right under the eyes of regulators, in the middle of a historic series of government bailouts! In fact, the amount of failed trades in Treasury bonds — the equivalent of "phantom" stocks — has doubled since 2007. In a single week last July, some $250 billion worth of U.S. Treasury bonds were sold and not delivered.

The counterfeit nature of our economy is troubling enough, given that financial power is concentrated in the hands of a few key players — "300 white guys in Manhattan," as a former high-placed executive puts it. But over the course of the past year, that group of insiders has also proved itself brilliantly capable of enlisting the power of the state to help along the process of concentrating economic might — making it less and less likely that the financial markets will ever be policed, since the state is increasingly the captive of these interests.

The new president for whom we all had such high hopes went and hired Michael Froman, a Citigroup executive who accepted a $2.2 million bonus *after* he joined the White House, to serve on his economic transition team — at the same time the government was giving Citigroup a massive bailout. Then, after promising to curb the influence of lobbyists, Obama hired a former Goldman Sachs lobbyist, Mark Patterson, as chief of staff at the Treasury. He hired another Goldmanite, Gary Gensler, to police the commodities markets. He handed control of the Treasury and Federal Reserve over to Geithner and Bernanke, a pair of stooges who spent their whole careers being bellhops for New York bankers. And on the first anniversary of the collapse of Lehman Brothers, when he finally came to Wall Street to promote "serious financial reform," his plan proved to be so completely absent of balls that the share prices of the major banks soared at the news.

The nation's largest financial players are able to write the rules for own their businesses and brazenly steal billions under the noses of regulators, and nothing is done about it. A thing so fundamental to civilized society as the integrity of a stock, or a mortgage note, or even a U.S. Treasury bond, can no longer be protected, not even in a crisis, and a crime as vulgar and conspicuous as counterfeiting can take place on a systematic level for years without being stopped, even after it begins to affect the modern-day equivalents of the Rockefellers and the Carnegies. What 10 years ago was a cheap stock-fraud scheme for second-rate grifters in Brooklyn has become a major profit center for Wall Street. Our burglar class now rules the national economy. And no one is trying to stop them.