IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
WASHINGTON MUTUAL, INC., *et al.*,[1]	Case No. 08-12229 (MFW)
Debtors.	Jointly Administered
	Objection Deadline: 12/20/2012 @ 4:00 p.m. (ET) **Hearing Date: 12/27/2012 @ 2:00 p.m. (ET)**

MOTION BY WMI LIQUIDATING TRUST FOR AN ORDER AUTHORIZING AN EXAMINATION OF GOLDMAN SACHS PURSUANT TO BANKRUPTCY RULE 2004

WMI Liquidating Trust ("**WMILT**") as successor in interest to Washington Mutual, Inc. ("**WMI**") and WMI Investment Corp. ("**WMI Investment**"), formerly debtors and debtors in possession (collectively the "**Debtors**") moves for authorization to conduct a limited examination of Goldman, Sachs & Co. and its affiliates including Goldman Sachs Execution & Clearing LP (collectively "**Goldman Sachs**" or "**Goldman**") pursuant to Rule 2004 of the Federal Rules of Bankruptcy Procedure (the "**Bankruptcy Rules**") and Rule 2004-1 of the local Rules for the United States Bankruptcy Court for the District of Delaware (the "**Local Rules**").

I. PRELIMINARY STATEMENT

1. WMILT seeks authorization to conduct discovery into potential claims against Goldman Sachs for breach of contract and related causes of action. Evidence recently developed

[1] Debtors in these Chapter 11 cases and the last four digits of each Debtor's federal tax identification numbers are: (i) Washington Mutual, Inc. (3725) and (ii) WMI Investment Corp. (5395). The Debtors are located at 925 Fourth Avenue, Suite 2500, Seattle, Washington 98104.

by WMILT's Litigation Subcommittee[2] suggests that these claims could be a source of substantial value to WMILT's remaining creditors and WMI's former equity holders.

2. Goldman Sachs was WMI's investment bank for years prior to WMI's bankruptcy. Goldman underwrote several of WMI's securities and WMI looked to Goldman for assistance in raising capital and seeking investment partners. This work on behalf of WMI became increasingly important as the financial crisis worsened and turbulence in the mortgage markets threatened WMI's subsidiary Washington Mutual Bank ("**WMB**"). Believing that the bank's asset base and capital position were adequate to weather the storm if it could find a reliable source of liquidity, WMI was counting on Goldman Sachs' reputation to bolster market confidence and help prevent a collapse. WMI hired Goldman Sachs, and paid it millions in fees, to seek out investors who could provide liquidity and to explain to these potential investors why WMI was sound.

3. Instead of providing this promised support to WMI, it appears that Goldman Sachs may have decided it could make more money by betraying its client. In this motion, WMILT seeks evidence of Goldman's participation in a scheme to drive WMI's stock price down as a way of generating massive profits for Goldman and its favored investor partners. Such conduct, if it occurred, was directly contrary to the obligations Goldman undertook in its investment advisory agreement with WMI.

4. There is little doubt that some major investors did participate in a scheme to drive down WMI's share price. In the final months before bankruptcy, WMI was the victim of a "bear raid", a frenzy of short sales and other securities transactions which had the effect—probably intentionally—of driving WMI's stock price into the ground. In such a situation, investors

[2] Capitalized terms used by not defined in this brief have the meaning ascribed to them in the Seventh Amended Joint Plan of Reorganization.

betting against a stock through short sales, for instance, can generate enormous profits by fomenting a self-perpetuating cycle of panic. As the SEC has recognized, financial institutions are particularly vulnerable to bear raids because their value is dependent on public perception of the institution's strength and stock crashes can lead quickly to bank runs, as they did for Washington Mutual, which can further depress the stock price and reinforce the adverse cycle.

5. The risk to financial institutions is amplified if investors are engaging in illegal "naked" short sales. In such transactions, investors seeking to profit from a bear raid will agree to sell stock short without first locating and obtaining shares to sell. In addition to the impact of the negative trading activity, significant amounts of naked short selling can artificially depress a stock's price by increasing the supply of shares in the market. Short sellers who are unconstrained by the need to locate shares can flood the market with sell orders, causing the price to crash. For these reasons, naked short selling is a recognized form of abusive market manipulation and is unlawful in almost all instances.

6. Currently available evidence is overwhelming that WMI's stock was subjected to a large amount of naked short selling in the months leading up the bankruptcy. There is also good reason to conclude that a substantial share of the decline in the stock's value during those months is attributable to shorting and naked shorting of WMI's stock, not to any inherent weakness in WMI. This potentially unlawful trading activity created a classic death spiral for the bank.

7. WMILT seeks discovery to determine whether Goldman Sachs participated in or facilitated the shorting and naked shorting of WMI's stock. Such activity, if it occurred, would be the basis for a breach of contract claim against Goldman and also potentially claims for market manipulation and other securities-related causes of action.

8. The trading records necessary to determine Goldman's involvement with shorting and naked shorting of WMI's stock are solely within Goldman's possession. Even without seeing these trading records there is good reason to suspect that Goldman participated in this activity. Goldman Sachs' involvement in bear raids and naked shorting of other stocks, including stocks of other financial institutions like Lehman Brothers, has been widely reported in the press. Goldman has also been named as a defendant in several cases alleging naked short selling. Discovery in at least one of those cases has turned up evidence that Goldman had a practice of facilitating naked short sales for favored investor clients, and even that Goldman was the "go to" firm for hedge fund managers who wanted to short a stock that could not be obtained elsewhere.

9. WMILT seeks discovery of the relevant trading records in order to determine whether it has a basis for bringing a claim against Goldman Sachs for this activity. The burden on Goldman from having to produce these records should not be significant given the very limited scope of the request. On the other hand, the potential benefit to WMI's creditors and other stake holders is substantial given the magnitude of the damages at issue. Granting this motion will facilitate WMILT's efforts to fulfill its fiduciary obligation to its constituents to identify and liquidate all claims that it received from the estate.

II. JURISDICTION AND VENUE

10. This Court has jurisdiction to decide this matter pursuant to 28 U.S.C. §§157 and 1334. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(A) & (O). Venue is proper in this Court pursuant to 28 U.S.C. §§1408 and 1409.

11. The predicates for the requested relief are Bankruptcy Rule 2004 and Local Rule 2004-1.

III. FACTUAL BACKGROUND

A. WMI's Bankruptcy And The Creation Of WMILT

12. On September 26, 2008, WMI filed a petition for relief under Chapter 11. The bankruptcy case was jointly administered with the case of WMI's affiliate WMI Investments, which filed on the same day. WMI and WMI Investments served as debtors in possession throughout the pendency of the bankruptcy.

13. On February 23, 2012, this Court approved the Seventh Amended Joint Plan of Reorganization (the "**Plan**"). The Plan was the product of an extensive negotiation between various stakeholders, including the Debtors, the Committee of Unsecured Creditors, and the Committee of Equity Holders. The Plan received overwhelming support from WMI's stakeholders, including its equity investors who received majority ownership in the reorganized debtor and an interest in any post-confirmation litigation. The Plan became effective on March 19, 2012.

14. Pursuant to the Plan, WMILT was formed, among other reasons, to manage the resolution of all remaining claims, both those against the Debtors and those that might be brought on behalf of the Debtors or other stakeholders. Also pursuant to the negotiated terms of the Plan, a subcommittee of WMILT was formed for the purpose of investigating any affirmative claims that WMILT might bring against third parties (the "**Litigation Subcommittee**"). Under the Plan, certain funds were allocated from the estate to the Litigation Subcommittee to be used in the investigation and prosecution of any potential claims.

B. The 2008 Financial Crisis And Seizure of Washington Mutual Bank.

15. Prior to filing for bankruptcy, WMI was a multiple savings and loan holding company that owned WMB and several other non-banking subsidiaries. As a savings and loan,

WMB was regulated by the Office of Thrift Supervision ("**OTS**").

16. In the midst of the 2008 global financial crisis, WMI injected billions of additional capital into WMB during the summer of 2008 and sought outside investors to provide additional capital and liquidity.

17. Despite these efforts, on September 25, 2008 the Director of the OTS appointed the FDIC as receiver for WMB and advised that the receiver was immediately taking possession of WMB. Immediately after its appointment as receiver, the FDIC sold substantially all of the assets of WMB to JPMorgan Chase Bank, National Association.

C. Goldman's Involvement In Efforts To Save WMI.

18. Goldman Sachs had been WMI's investment bank for years prior to the bankruptcy. Goldman had served as underwriter on several series of WMI debt and equity securities and, in the spring of 2008, Goldman had played a significant role in facilitating the seven billion dollar investment in WMI led by the hedge fund TPG.

19. Given the history of this relationship and Goldman's knowledge of WMI and WMB's assets and business operations, WMI relied on Goldman as its partner in seeking an investor during the 2008 crisis. Goldman's reputation as one of the largest and most profitable investment banks in the world would, WMI hoped, give potential investors confidence in WMI despite the ongoing financial crisis. Indeed, WMI paid Goldman millions of dollars in large part because of Goldman's reputation and its connections.

20. Although Goldman and WMI did not enter into an agreement memorializing the terms of this engagement until September 24, 2008, just two days before the bankruptcy, the engagement actually started earlier. As the contract itself makes clear, WMI was agreeing to pay

Goldman Sachs $3 million "for services provided to date." *See* Exhibit 1, Letter Agreement, September 24, 2008, at ¶ 3.

21. In the contract, Goldman agreed to undertake the duties of "financial advisor" in conjunction with a potential "sale of all or a portion of the Company [i.e. WMI]." *Id.* at p. 1, preamble. Goldman's duties were defined more specifically in the first two paragraphs of the contract:

> (1) During the term of our engagement, we will provide you with financial advice and assistance in connection with this potential transaction, which may include performing financial analyses, searching for a purchaser or investors acceptable to you, coordinating visits of potential purchasers and investors and assisting you in negotiating the financial aspects of the transaction;
>
> (2) At your request we also will undertake a study to enable us to render our opinion as to the fairness from a financial point of view of the financial consideration to be received by shareholders of the Company in connection with the sale of 50% or more of the outstanding common stock of the Company.

Id. at ¶¶ 1 and 2.

D. Naked Short Sales Impacted WMI's Share Price

22. In the months preceding the bankruptcy, the price of WMI's common stock collapsed. It dropped from its 2008 high of nearly $22 per share on February 1st to just $2.26 on September 24th, the last day before the seizure of WMB.

23. Undoubtedly, a portion of this decline is attributable to the overall decline in the stock market. And another portion can be attributed to public releases of negative information concerning WMI and WMB as the economic crisis unfolded. But those factors alone do not explain the entire loss in value.

24. In conjunction with its investigation into potential claims, WMILT's Litigation Subcommittee retained an economist, Dr. Robert Shapiro, to analyze the causes of price changes

in WMI's stock between mid-2007 and September 24, 2008. Using widely accepted methods of statistical analysis, Dr. Shapiro isolated the effect of general market declines and the effects of publicly available news about WMI. *See* Exhibit 2, Declaration of Dr. Robert Shapiro, November 29, 2012, at ¶¶ 5-9. He determined that causes *other than these* appear to have contributed at least 24% of WMI's loss in value. *Id.* at ¶ 9. These other causes at least potentially include the effect of abundant short sales and naked short sales of WMI's stock. *Id.* at ¶¶ 4, 17.

25. In a second portion of his analysis, Dr. Shapiro examined publicly available data to gauge the level of short selling activity for WMI stock in the relevant period. He found substantial evidence of abnormally high levels of short selling and naked short selling. *Id.* at ¶¶ 10-18. He also found evidence of cross-causation, indicating that the volume of short sales tended to increase the volume of naked short sales and vice versa. *Id.* at 17.

26. As Dr. Shapiro explains, publicly available data makes a strong circumstantial case that WMI was the victim of "large-scale naked short activities." *Id.* at ¶ 13. The SEC publishes daily reports showing the number of trades of every stock that fail because the seller does not deliver the promised shares. *Id.* at ¶ 14. These "failures to deliver" can sometimes be caused by things other than a naked short sale, but naked shorts are by far the most common explanation and a large volume of these fails almost inevitably points to a pattern of naked shorting. *Id.* at ¶ 13.

27. In WMI's case, the pattern is unmistakable. Dr. Shapiro examined the monthly high number of failures to deliver WMI stock. He identified a very large volume of failures to deliver in the months leading up to the bankruptcy. *Id.* at ¶ 14. Failures to deliver increased sharply in the four quarters prior to the company's collapse, peaking at 42 million shares at the

time of the collapse in September 2008, the equivalent of 2.44 percent of WMI's outstanding shares and 9.7 percent of WMI's short interest. *Id.*

E. The Mechanics Of Short Sales And Naked Short Sales

28. To sell a stock short, an investor borrows the necessary shares through a broker who usually locates the shares. Most major brokerages have lending desks that will arrange such transactions (for a fee) to facilitate short sales. The investor then sells the borrowed shares to a buyer in the market at the current market price and is obliged to deliver the borrowed shares within three days of the sale (T+3). Because of the outstanding obligation to return the shares to the lending broker, the investor must at some future point acquire replacement shares in the market. If, as the short-seller hopes, the price of the shares declines, the investor will be able to purchase replacement shares for less than the cash he or she received from the buyer, netting a profit. If, on the other hand, the share price rises, the investor will pay more when he or she buys replacement shares and will sustain a loss.

29. An investor engaging in a *naked short* sale sells shares to a buyer without first locating them through a broker or delivering them within three days of the sale. In such a case, the Depository Trust Corporation ("**DTC**"), the securities clearinghouse owned by the major investment banks and brokerage houses, credits the buyer with shares and establishes an obligation for the broker of the naked short seller to locate shares and deliver them. This obligation may not be satisfied for weeks or even months. During the period when such a trade has not been settled by the original seller, the DTC will nevertheless treat the credits held by the buyer as if they were actual shares, allowing them to be traded as if they were genuine shares.

30. This process can create an opportunity for blatant market manipulation and fraud. Short sellers who are not constrained by the obligation to locate and borrow the shares they sell

are able to generate a massive number of sell orders, potentially flooding the market and driving down the price. When these short sellers fail to deliver, the DTC-generated "phantom shares" can accumulate in the market in addition to the actual shares legally issued by the corporation. When naked short selling of a particular stock reaches high levels, as it apparently did for WMI, a significant share of the stock in the market place may be false shares. There is no doubt that an increase of this size in the supply of available shares, especially for an actively traded stock, can create substantial downward pressure on the price of the shares. In addition, other market participants observe the large short sales occurring without knowing they are naked short sales. These other participants may assume that the short seller has reliable negative information about the company that would justify the large short sales, including the fees paid to borrow the shares. In this way, naked short sellers inject false information into the market, sending negative signals about a company that can further depress its share price.

F. Naked Short Sales Helped Bring Down Other Financial Institutions Including Bear Sterns And Lehman.

31. News articles have reported the wide-spread allegation that both Bear Sterns and Lehman Brothers were brought down by bear raids, including extensive naked shorting. *See, e.g.* Exhibit 3, Gary Matsumoto, *Naked Short Sales Hint Fraud in Bringing Down Lehman*, Bloomberg, March 19, 2009; Exhibit 4, Matt Taibbi, *Wall Street's Naked Swindle,* Rolling Stone, October 15, 2009.

32. In the wake of the Bear Sterns collapse, the SEC recognized the particular vulnerability of financial institutions to bear raids because of their dependence on public confidence. As a result, the SEC issued an emergency order stepping up the protection against naked short selling for certain major financial institutions. Exhibit 5, *SEC Enhances Investor Protections Against Naked Short Selling*, SEC Press Release 2008-143, July 15, 2008. The list

of protected companies did not include WMI (though it did include Goldman Sachs). *Id.* SEC Chief Christopher Cox described the action as intended to "stop unlawful manipulation through 'naked' short selling that threatens the stability of financial institutions." *Id.*

33. Goldman Sachs has been identified as a likely participant in the bear raids on Bear Sterns and Lehman Brothers. Richard Fuld, former CEO of Lehman Brothers, was apparently convinced of Goldman's involvement, though he acknowledged to Congress that he had no hard proof. *See* Exhibit 6, Heidi N. Moore, *Dick Fuld's Vendetta Against Short Sellers And Goldman Sachs*, Wall Street Journal Blogs, October 7, 2008 (quoting an email from Lehman executive Thomas Humphrey, "that in just a few weeks on the 'buy' side,...it is very clear that GS is driving the bus with the hedge fund kabal& greatly influencing downside momentum,Leh & others!") Press accounts have also insinuated that Goldman was involved. *See, e.g.,* Exhibit 4, Matt Taibbi, *Wall Street's Naked Swindle,* Rolling Stone, October 15, 2009.

G. Goldman Has Been Implicated In Other Naked Shorting Cases

34. Goldman Sachs has been at the center of the controversy surrounding naked short selling for years. It has been fined by the SEC for this activity. It has been sued by shareholders for market manipulation based on naked shorting. And documents produced in one of those cases support the claim that, for Goldman, naked short selling was a standard business practice.

35. In 2007 Goldman paid $2 million the SEC to resolve claims that it had facilitated an illegal short-sale trading scheme for some of its clients. *See* Exhibit 7, *SEC and NYSE Settle Enforcement Actions Against Goldman Sachs Unit for Role in Customers Illegal Trading Scheme*, SEC press release 2007-41, March 14, 2007. Goldman's clients in that case were placing orders to sell shares that they did not own, effectively executing naked shorts. The SEC

alleged that Goldman knew or should have known of these abusive trades and, instead of reporting the violations, helped facilitate the scheme. *Id.*

36. Goldman settled a second naked short selling case brought by the SEC and the NYSE in May 2010. *See* Exhibit 8, Mary Gordon, *Goldman Sachs Settles Short Sales Allegations*, USA Today, May 4, 2010. In this enforcement action, the SEC alleged that Goldman Sachs Execution & Clearing violated regulations by failing to deliver or locate shares in order to close out certain short sales. *Id.* These failures to deliver violated regulations intended to prevent naked short selling. The allegations in this enforcement action are particularly relevant to WMI because the trades at issue occurred in December 2008 and January 2009, just a few months after WMI collapsed.

37. Goldman Sachs has also been named as a defendant in a number of private lawsuits alleging market manipulation through naked short schemes. In one such case, brought by Internet retailer Overstock.com in California state court, documents obtained in discovery from Goldman were disclosed in a public filing.[3] A number of these documents relate not just to Overstock.com trades, but to an apparent pattern of willful failures to deliver extending across the firm. Detailed review of this evidence is contained in a brief from the case. *See* Exhibit 9, Plaintiffs' Consolidated Opposition to Defendants' Motions To Seal Summary Judgment Papers, February 9, 2012. Examples include an email from one of Goldman's hedge fund clients noting that when they asked Goldman "to short an impossible name (and expecting full well not to receive it) [they would be] shocked to learn that [Goldman] can get it for us." *See id.* at p. 19. In another email, a Goldman executive states that "we have to be careful not to link locates to fails [because] we have told the regulators we can't." *Id.*

[3] The Overstock.com case was dismissed by the trial court on jurisdictional grounds unrelated to Goldman's actual involvement in any naked short transactions. It is currently on appeal.

H. Goldman's Market Manipulation Through Shorting And Naked Shorting Would Give Rise To Liability.

38. Evidence of Goldman Sachs' participation in a naked short selling scheme targeting WMI could serve as the basis for claims under several theories. WMILT may have a claim against Goldman for breach of the investment advisory agreement. Goldman's participation in an intentional and unlawful scheme to drive down WMI's stock price would be directly contrary to Goldman's contractual obligations to support and advise WMI in its efforts to find an investor. Under New York law, conduct that would "deprive the other party of the right to receive the benefits under their agreement" constitutes a breach of the duty of good faith and fair dealing. *See, e.g., Jaffe v. Paramount Commc's,* 222 A.D.2d 17, 22–23, 644 N.Y.S.2d 43 (App. Div. 1st Dept. 1997). Certainly engaging in unlawful conduct intended to drive WMI's stock price into the ground could be seen to deprive WMI of its ability to benefit from Goldman's promised efforts to locate an investor.

39. WMILT may also have claims under applicable securities laws. When unlawful naked short selling is intended to impact the market price of a stock, it can serve as the basis for securities fraud and market manipulation claims under Section 10(b). *See, e.g. CompuDyne Corp. v. Shane*, 453 F.Supp.2d 807, 827 (S.D.N.Y. 2006). WMILT may also have claims for insider trading, breach of contract, or misuse of confidential information if, in making trading decisions, Goldman used information it received from WMI. A detailed assessment of damages is obviously premature, but there is no doubt that the damages from any of these claims could be very significant given the impact that naked short selling may ultimately have had on WMI.

IV. ARGUMENT

A. An Investigation Into Potential Claims Against Goldman Is A Proper Subject For Rule 2004 Discovery

40. WMILT seeks an order authorizing it to take discovery, including the production of documents and a deposition of a Goldman Sachs corporate representative under Fed. R. Civ. P. 30(b)(6), on topics related to Goldman's trading activity and securities lending activity concerning any WMI issued security during the period from March 25, 2008 through September 25, 2008.

41. Rule 2004(a) of the Federal Rules of Bankruptcy Procedure permits any party in interest to move for an examination of any entity. "The scope of a Rule 2004 examination is unfettered and broad." *Wash. Mut., Inc.* 408 B.R. 45, 49 (Bankr. D. Del. 2009) (internal punctuation and citation omitted). Rule 2004 examinations are often equated to a "fishing expedition" and are not necessarily premised on any threshold showing of likelihood of success. *See, e.g., In re Bennett Funding Group, Inc.*, 203 B.R. 24, 28 (Bankr. N.D.N.Y. 1996). The power is not unlimited, however, and examinations cannot invade areas that are not relevant to the basic matter being investigated and cannot be used to harass. *In re Table Talk, Inc.*, 51 B.R. 143, 145 (Bankr. D. Mass. 1985).

42. The primary purpose of a Rule 2004 examination is to enable the trustee to determine the full extent of the estate, including all claims and other assets. *In re Drexel Burnham Lambert Group, Inc.*, 123 B.R. 702, 708 (Bankr. S.D.N.Y. 1991). Furthermore, a Bankruptcy Rule 2004 examination "may extend to creditors and third parties who have had dealings with the debtor." *In re Wilcher*, 56 B.R. 428, 433 (Bankr. N.D. Ill. 1985). Emphasizing the broad purposes of Rule 2004, courts have generally permitted examination of any third-party who had business dealings with the debtor. *In re Ionosphere Clubs, Inc.*, 156 B.R. 414

(S.D.N.Y. 1993), *aff'd*, 17 F.3d 600 (2nd Cir. 1994). As this Court recognized in granting the Debtor's prior motion for a Rule 2004 examination in this case, "[l]egitimate goals of Rule 2004 examinations include 'discovering assets, examining transactions, and determining whether wrongdoing has occurred.' " *In re Wash. Mut. Inc.*, 408 B.R. at 50 (quoting *In re Enron Corp.*, 281 B.R. 836, 840 (Bankr. S.D.N.Y. 2002)).

B. Plan Confirmation Does Not Render Rule 2004 Unavailable

43. Rule 2004 discovery remains available after confirmation of a plan of reorganization. *See, e.g., In re Kelton*, 389 B.R. 812, 820 (Bankr. S. D. Ga. 2008) (granting trustee's motion for a post-confirmation Rule 2004 examination of the debtor); *In re Sun Medical Management, Inc.*, 104 B.R. 522, 525 (M.D. Ga. 1989) (granting debtor's motion for a post-confirmation Rule 2004 examination of parties who may have been involved in a fraudulent conveyance.)

44. Post-confirmation use of Rule 2004 is particularly appropriate when, as here, the Plan created a Trust charged with the duty of pursuing pre-petition causes of action and the requested discovery relates to pre-petition misconduct by a third-party. *In re Daisytek, Inc.*, 323 B.R. 180, 186 (N.D. Tex. 2005) (holding that the bankruptcy court retains jurisdiction to order Rule 2004 examinations on behalf of a trust that has been assigned the estate's causes of action). The use of Rule 2004 by a trust formed for the benefit of the estate's remaining stakeholders is no different from the use of the rule by the debtor; the same justifications for the Rule exist to benefit the same parties. *Id.*

45. The discovery requested in this motion falls squarely within the parameters of Rule 2004. WMILT seeks to investigate a potentially significant asset of the former estate, a litigation claim against Goldman Sachs for pre-petition misconduct. WMILT has performed an

extensive investigation of publicly available information relevant to the potential claims and determined that there is a reasonable basis to conclude that Goldman may be liable for unlawful naked short selling of WMI stock, as explained above. The scope of the requested discovery, records of Goldman's trading and lending activities for a six month period, is narrow and the burden on Goldman consequently limited. No prior Rule 2004 examination has been conducted into these issues.

C. The Claims WMILT Seeks To Investigate Were Not Addressed By The Examiner.

46. The Report of the Examiner appointed by this Court does not eliminate the need for the Rule 2004 discovery sought in this motion. As the Report itself makes abundantly clear, the Examiner's investigation into third-party claims not resolved in the settlement with JP Morgan Chase was "limited" and "not a dispositive analysis." Final Report of the Examiner, dated November 1, 2010 at p. 329 [Docket No. 5735]. As the Examiner emphasized, "[n]o final conclusions have been reached with respect to the merits of any [third-party] claims discussed herein, all of which would require further factual development to make final conclusions." *Id.* at 329-330. The Examiner expressly stated that the Debtors' representatives would pursue these third-party claims following confirmation. *Id.* at p. 329 n. 1355.

47. The Examiner did not even consider claims against Goldman for unlawful naked shorting. His investigation was limited to insider trading or breaches of confidentiality: "Any potential theories of recovery against Goldman Sachs by the Estates would ultimately be based on misuse of WMI's confidential information." *Id.* at p. 331.

48. The Examiner did briefly consider short-selling as the basis of a potential claim, but only conventional, lawful short-selling. His determination that Goldman would not have breached its investment advisory agreement by holding a short position in WMI stock was based

entirely on a clause in the agreement permitting Goldman to "hold long and short positions" in WMI securities. *Id.* at p. 333 and 334. This clause would not excuse Goldman's execution of unlawful naked shorts or its participation in a scheme to artificially depress WMI's stock price, which are the theories WMILT seeks to investigate.

49. The Examiner received a statement from Goldman Sachs summarizing certain trading activity of WMI common stock for each of the four quarters of 2008. *See id.* at 333. This chart does not provide the information WMILT seeks in this motion. It apparently reflects only purchases and sales of WMI's stock, not options or other derivative instruments. It is restricted to Goldman divisions or affiliates that it identifies as "proprietary trading business units", a limitation the scope of which must be further explored. *See id.* at p. 332 n. 1371. Perhaps most importantly, it does not reflect any activity by Goldman's lending desk, which may have been facilitating naked short sales by agreeing to lend shares Goldman did not own.

V. CERTIFICATION UNDER DEL. BANKR. L.R. 2004-1(b)

50. Edgar Sargent certifies that pursuant to Local Rule 2004-1(b) that he, as counsel for the Litigation Subcommittee of the WMI Liquidating Trust, participated in multiple communications with counsel for Goldman Sachs in an attempt to agree on the voluntary production of these documents; unfortunately, no agreement has been reached.

VI. NOTICE

51. No trustee has been appointed in these chapter 11 cases. Notice of this Motion has been provided to: (i) the Office of the United States Trustee for the District of Delaware, (ii) Goldman Sachs, (iii) counsel for Goldman Sachs, and (iv) those parties entitled to receive notice in these chapter 11 cases pursuant to Bankruptcy Rule 2002 and Local Rule 2004-1. In light of

the nature of the relief requested, WMILT submits that no other or further notice need be provided.

VII. CONCLUSION

52. For the foregoing reasons, WMILT respectfully requests that the Court (i) grant the relief requested in this Motion and authorize an examination of Goldman Sachs pursuant to Bankruptcy Rule 2004; and (ii) grant such further relief as is just and proper.

Dated: November 30, 2012
Wilmington, Delaware

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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
WASHINGTON MUTUAL, INC., *et al.*,[1]	Case No. 08-12229 (MFW)
Debtors.	(Jointly Administered)
	Ref. No. ___

ORDER GRANTING MOTION BY WMI LIQUIDATING TRUST FOR AN ORDER AUTHORIZING AN EXAMINATION OF GOLDMAN SACHS PURSUANT TO BANKRUPTCY RULE 2004

Upon consideration of the Motion (the "**Motion**")[2] of WMI Liquidating Trust ("**WMILT**") as successor in interest to Washington Mutual, Inc. ("**WMI**") and WMI Investment Corp. ("**WMI Investment**"), formerly debtors and debtors in possession (collectively the "**Debtors**"), for entry of an order pursuant to Rule 2004 of the Federal Rules of Bankruptcy Procedure (the "**Bankruptcy Rules**") and Rule 2004-1 of the Local Rules for the United States Bankruptcy Court for the District of Delaware (the "**Local Rules**") for authorization to conduct a limited examination of Goldman, Sachs & Co. and its affiliates including Goldman Sachs Execution & Clearing LP (collectively "**Goldman Sachs**" or "**Goldman**"); the Court having reviewed the Motion and having heard the statements of counsel in support of the relief requested therein at a hearing (the "**Hearing**"); the Court finding that (a) the Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334, (b) this is a core proceeding pursuant to 28 U.S.C. § 157(b)(2); the Court finding that notice of the Motion given by WMILT

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[1] Debtors in these Chapter 11 cases and the last four digits of each Debtor's federal tax identification numbers are: (i) Washington Mutual, Inc. (3725) and (ii) WMI Investment Corp. (5395). The Debtors are located at 925 Fourth Avenue, Suite 2500, Seattle, Washington 98104.

[2] Capitalized terms used by not otherwise defined in this Order shall have the meaning ascribed to them in the Motion.

was sufficient under the circumstances; and the Court being fully advised in the premises and having determined that the legal and factual bases set forth in the Motion and at the Hearing on the Motion establish just cause for the relief herein granted;

IT IS HEREBY ORDERED THAT:

1. The Motion is hereby GRANTED.

2. WMILT is hereby authorized to take discovery, including the production of documents and a deposition of a Goldman Sachs corporate representative under Fed. R. Civ. P. 30(b)(6), on topics related to Goldman's trading activity and securities lending activity concerning any WMI issued security during the period from March 25, 2008 through September 25, 2008.

3. The Court shall retain jurisdiction over any matter or dispute arising from or relating to the implementation of this Order.

Dated: December ___, 2012
Wilmington, Delaware

Honorable Mary F. Walrath
United States Bankruptcy Court Judge

Exhibit 9

Theodore A. Griffinger, Jr. (SBN 66028)
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CONDITIONALLY FILED UNDER SEAL

SUPERIOR COURT OF THE STATE OF CALIFORNIA

COUNTY OF SAN FRANCISCO

OVERSTOCK.COM, INC., a Delaware corporation; KEITH CARPENTER, an individual; OLIVIER CHENG, an individual; FERN BAILEY and WENDY MATHER, as Co-Personal Representatives of the Estate of MARY HELBURN; ELIZABETH FOSTER, an individual; HUGH D. BARRON, an individual; DAVID TRENT, an individual; and MARK MONTAG, an individual,

Plaintiffs,

v.

MORGAN STANLEY & CO., et al.,

Defendants.

Case No. CGC-07-460147

PLAINTIFFS' CONSOLIDATED OPPOSITION TO DEFENDANTS' MOTIONS TO SEAL SUMMARY JUDGMENT PAPERS

Date: March 1, 2012
Time: 9:30 a.m.
Dept: 305
Judge: Hon. John Munter

Complaint Filed: February 2, 2007

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"[C]ommon sense tells us that the greater the motivation a corporation has to shield its operations, the greater the public's need to know." *Brown & Williamson Tobacco Corp. v. FTC*, 710 F.2d 1165, 1180 (6th Cir. 1983).

"[W]hat transpires in the court room is public property." *Craig v. Harney*, 331 U.S. 367, 374 (1947).

"[T]raditional Anglo-American jurisprudence distrusts secrecy in judicial proceedings and favors a policy of maximum public access to proceedings and records of judicial tribunals." *Estate of Hearst*, 67 Cal. App. 3d 777, 784 (1977).

I. INTRODUCTION

In prior discussions with the parties, the Court advised that it was not meting out private justice as a Star Chamber and that Defendants should be selective in determining what they seek to seal. Completely and utterly disregarding the Court's guidance, Defendants seek to seal virtually everything submitted with the summary judgment papers, including virtually every single evidentiary document and deposition excerpt submitted in opposition to summary judgment, as well as large portions of the summary judgment opposition, the seven supporting declarations from plaintiffs' expert witnesses that set forth Defendants' manipulation, and Defendants' reply papers. Just as Defendants abused the summary judgment objections process by objecting to virtually every document, Defendants have likewise again burdened both the Court and Plaintiffs with having to address their massive filing, much of which is completely frivolous. Plaintiffs are unaware of any California case where a party has tried to do anything even close to what Defendants are doing here – globally seal virtually every piece of evidence Plaintiffs submitted in opposition to summary judgment.

Defendants rely on two primary arguments for their global sealing request. First, Defendants contend that the Court need only make a sealing determination as to some undefined subset of summary judgment materials that the Court "considered or relied upon as a basis of adjudication" in denying summary judgment. Goldman Motion, at 7. However, even the legal authority cited by Defendants requires a sealing determination of all summary judgment materials, not some portion. Not only is Defendants' argument legally baseless, it is also

factually impossible because the essence of the Court's order is its finding—after reviewing all of the evidence—that the manipulative conduct occurred outside California. There is no way for the public to assess the fairness and validity of that conclusion without reviewing all of the evidence, nor is there any way for the Court to parse what evidence was or was not considered or relied upon in reaching its conclusion that the manipulative conduct occurred outside California. The public is entitled to see that evidence and make its own determination of whether the Court erred in dismissing the case based on what Defendants characterized as "jurisdictional limitations" of Section 25400. Even if those limitations were correctly applied by the Court, the public may wish to reconsider the scope of the statute. In either case, the public has a right to know how justice is rendered in its court system.

Second, despite moving to seal virtually the entire record, Defendants have failed to enumerate "specific facts" that justify what the California Court of Appeal refers to as the "extraordinary" measure of sealing any record—much less all of these years-old records. Instead, Defendants rely upon generic statements that all of these documents contain trade secrets, yet ignore the fact that much of the information they seek to seal is already in the public domain. The remainder is of no competitive value to anyone because the information is limited in scope and concerns obsolete procedures from six to seven years ago that were unlawful at the time and that are further blocked by the enactment of new federal regulations in 2008.

Defendants proffer generic conclusions about the supposed trade secret status of the materials at issue. That is a risible fiction. Such "trade secrets" represent nothing more than Defendants' efforts to hide evidence of how they intentionally failed trades and the nature of their relationship with two traders, Scott Arenstein and Steven Hazan (who have been suspended from the securities industry for a minimum of five years and sanctioned millions of dollars each). Indeed, Defendants seek to seal the materials reflecting the very policies that they claimed at oral argument were common knowledge: "[I]t was common knowledge in the marketplace that Merrill Pro and GSEC were not borrowing shares for market-maker trades because we were doing it for all of our market-maker customers. It wasn't just for Hazen [sic]." Jan. 5, 2012 Tr., at 23:21-24.[1]

[1] An additional copy of the summary judgment hearing transcript is attached to the Declaration of

Defendants' counsel further emphasized that "this case is about firmwide policies by Merrill Pro and GSEC to fail the short—the short sales of our market-maker clients." *Id.* at 167:7-10. Defendants now reverse course and claim that the emails and other evidence reflecting how they failed trades, why they failed trades, and who approved and disapproved of failing trades are all trade secrets. Defendants go so far as to request sealing of documents whose contents have already been substantially revealed, as set forth in the Factual Background below.

Whereas an order unsealing records requires no factual findings, a sealing order under California Rule of Court 2.550 requires, among other things, "express factual findings" for each record sealed establishing that Defendants have an interest that overrides the right of public access and that disclosure would prejudice Defendants. Before sealing any record, the Court must review the specific document to make the determinations of whether Defendants have established an overriding interest and would suffer prejudice and, if so, whether some portion of the document may still be disclosed in redacted form. Stale six and seven-year old emails should not be sealed merely because they reflect the Defendants' plan to fail trades and scheme with persons like Hazan and Arenstein in so doing. Embarrassment and a desire to hide wrongdoing do not qualify as an "overriding interest."

Defendants' refusal to identify any potentially confidential evidence within the overall evidence has forced Plaintiffs to spend massive amounts of time pointing out, document by document, how the mass of what Defendants seek to seal is already in the public record or otherwise does not meet the well-established standards for sealing records. Additionally, by requesting that the Court enter a global sealing order of the summary judgment papers and not submitting any redacted versions of any potentially sealable documents, Defendants have waived any claim that some lesser portion of a document or documents may be sealed. Where such a global sealing order is improperly requested, the law mandates unsealing of the entire record.

Ellen Cirangle in Support of Plaintiffs' Consolidated Opposition to Motions to Seal ("Cirangle Dec."), Ex. A.

II. FACTUAL BACKGROUND

A. Facts Already in the Publicly-Available Record in This Case

All of the following facts are taken from publicly-available filings and court records, with particular reliance on filings made by Defendants themselves.

Defendants' own witnesses have repeatedly stated that there is a T+3 delivery requirement for all short sales.[2] *See* Defendants' Responses and Objections to Additional Evidence Submitted by Plaintiffs in Opposition to Defendants' Motion for Summary Judgment, Or, Alternatively, Summary Adjudication ("Defendants' Responses")[3], Fact No. 255. Defendants are responsible for delivery of stock, even on market maker trades. *Id.*, Fact No. 134. Other clearing firms settled market maker short sales at T+3.[4] *Id.*, Fact No. 256. Morgan Stanley, Goldman's longtime competitor in securities lending (the two firms had the largest securities lending operations on Wall Street in 2006), made delivery for all stocks and promptly resolved any inadvertent failures-to-deliver, including for the very hard-to-borrow stocks, and that was industry practice. *Id.*, Fact No. 150. As experienced clearing firms, Defendants also know that intentionally failing market maker trades is inconsistent with industry custom and practice. *Id.*, Fact No. 176. Goldman executives acknowledged that prompt settlement was important, that negative rebate stocks should be settled just like any other stocks, and that letting market maker trades fail would not be consistent with Goldman policies. *Id.*, Fact No. 173.

Clearing firms' difficulty in borrowing Overstock placed a natural, market-based limit on short interest. Overstock was one of a small number of hard to borrow securities that were the focus of the day-to-day work in securities lending. Overstock was so hard to borrow that clearing brokers in 2006 charged borrow fees as high as 35% annualized. When a short seller would contact a clearing firm to inquire about short selling Overstock, the firm would sometimes

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[2] "T+3" is an industry term that refers to settlement three days after trade date.

[3] An additional copy of this pleading is attached as Exhibit B to the Cirangle Dec. for the Court's convenience.

[4] For example, O'Connor and Fortis, charged a borrow fee at settlement time for market maker shorts, and Morgan Stanley did not intentionally fail market maker trades after Reg SHO was implemented. *Id.*, Fact No. 256.

have to tell the short seller that no short sale could be executed because the firm had no inventory of the stock; if the broker could locate some stock, the broker typically had to pay a large fee to borrow the stock from a lender (such as custodial banks like State Street or Bank of New York) which the broker would in turn pass to the short seller with an added fee tacked on; and the short seller then had to decide whether it was willing to risk shorting a stock knowing that the stock had to, for example, drop 35% just for the short seller to break even. Defendants' Responses, Fact 135. All clearing firms, including Merrill and Goldman, faced, and would have been aware of, the same supply constraints for Overstock. Everyone "on the Street" constantly talked to other brokers looking for stock and therefore had a realistic, shared sense of how hard it was to locate stock and how expensive it was to borrow. All the brokers faced the same general supply-and-demand constraints when a stock, like Overstock, was hard to borrow. *Id.*, Fact 136.

Facing the same supply constraints as all of the other brokers, Defendants decided to manipulate supply and demand for short sales by consciously opting not to settle certain short sales in hard to borrow stocks, including Overstock, at all. Defendants' Responses, Fact No. 137. Both Goldman Sachs and Merrill Lynch decided to create fails-to-deliver in their affiliates, GSEC and Merrill Pro, so that they could correspondingly create "supply" in Goldman Sachs and Merrill Lynch. Millions of shares of fails-to-deliver were concentrated in GSEC/Merrill Pro so that millions of shares of corresponding "supply" could be artificially created in Goldman Sachs/Merrill Lynch.[5] Defendants used the supply of Overstock stock freed up by their intentional fails to deliver in Merrill Pro and GSEC to cause additional short selling in Overstock at Merrill Lynch and GS&Co. *Id.*, Fact No. 139. Goldman Sachs expressed its "intentions to create supply and perpetuate selling in stocks with a large amount of short interest." *Id.* Goldman was known for its ability to supply hard to borrow stock to its hedge funds that its competitors could not supply and that gave Goldman a competitive advantage. Goldman's own hedge fund clients remarked on how they would ask "to short an impossible name (and expecting full well not to receive it) and [be] shocked to learn that [Goldman's representative] can get it for us." Defendants' Responses, Fact 161.

[5] GSEC's fails were concentrated in its 501 and 690 DTCC accounts. *Id.* Facts 106-07.

Artificial supply created by fails increased the number of shares that could be lent out to short sellers. Defendants' Responses, Fact 161. Hedge fund clients were particularly interested in a stock that was "truly hard to borrow" and would "really trade like a 'TASR, OSTK.'" *Id.*, Fact 162. As the price of a hard-to-borrow security declines, the volume of short selling in the security will typically increase because of piling in, resulting in greater profits to the clearing firm. *Id.*, Fact 155. "Piling in" refers to the practice by which short sellers want to short stocks that are already being heavily shorted, further increasing the short pressure on the price of those stocks, like Overstock. Short sellers typically pile in to the same securities, which increases short interest in a small number of stocks. Client shorts were typically concentrated in the red hot stocks more than any other stocks, and short sellers believed that concentrated short selling in a small number of small to mid-cap companies could be expected to have a downward price effect as short interest increased. *Id.*, Fact 158.

Goldman Sachs also induced additional short sales through its circulation of the artificially high short interest in Overstock to its hedge fund clients. *Id.*, Fact 160. Goldman Sachs marketed highly shorted stocks, including Overstock, to clients by distributing lists of the top shorted stocks, knowing that it had the ability to offer its artificial supply. *Id.*, Fact 227. Goldman Sachs knew that such lists would alert holders of Overstock shares to the potential short-selling activities described and that by placing Overstock on such a list, Goldman Sachs was signaling to these holders that Overstock shares may be subject to further price declines owing to short selling which would trigger further sales in the broader market of Overstock's shares and further fuel price declines. Goldman Sachs circulated lists of the top shorted stocks to clients which Goldman Sachs would have understood was signaling to these holders Overstock might be subject to further price declines; the data Goldman Sachs circulated included the false, inflated short interest data. *Id.*, Fact 228. Short sales Goldman effected were part of the unnatural level of short interest that Goldman was able to generate through its use of artificial supply created by causing fails-to-deliver. *Id.*, Fact 118.

Defendants failed millions of shares in their GSEC and Merrill Pro accounts. Defendants' Responses, Fact 139. The fails and corresponding naked short sales artificially

increase the tradable supply of shares of Overstock available for short sales by as much as 34%, thus artificially increasing short sales beyond their normal supply constraints. *Id.*, Fact 157. The fails created supply in excess of six times the average daily trading volume of Overstock. Jan. 5, 2012 Tr., at 152. Defendants' decisions to intentionally fail to deliver Overstock stock caused large-scale naked short selling of Overstock stock. Defendants' Responses, Fact 151.

Goldman Sachs failed the negative rebate GSEC trades, including Overstock, by intentionally withholding supply from GSEC to settle their trades. Defendants' Responses, Fact 144. Goldman Sachs was the exclusive supplier of stock to GSEC, and the Securities Lending Group within Goldman Sachs borrowed stock and made the decision as to whether to retain that stock with Goldman Sachs or send it to its affiliates, including GSEC, for its affiliates' needs. *Id.*, Facts 142-3. Because GSEC would simply fail trades, its clients were artificially induced to short without regard to the true economics of the short sale. *Id.*, Fact 121.

Merrill's decision to intentionally fail these trades was accomplished through what Merrill called the "do-not-flip" process. Normally, all trades at Merrill Pro are flipped to Merrill Pierce for settlement in the ordinary course. The "do-not-flip" process applied to negative rate securities, that is securities that cost Merrill money to settle. That process is a process by which Merrill Pro does not borrow stocks to settle those trades, but rather fails them. After Reg SHO, Merrill Pro put the do-not-flip system into place in August 2005. Thomas Tranfaglia, Linda Messinger and Peter Melz were the Merrill executives who decided to do this in August 2005. Jan. 5, 2102 Tr., 64:11-66:7 (argument by Merrill's counsel).

Merrill Pro agreed to fail trades for Hazan and other market-making customers and stopped borrowing shares for their short sales. Jan. 5, 2012 Tr., 23:21-28 (argument by Merrill's counsel). In August 2005, Merrill Pro told clients that they would now start failing their trades.[6] Jan. 5, 2012 Tr., 74:20-26. After Merrill Pro agreed to fail trades for clients in negative rebate securities these clients naked short sold Overstock in large quantities. Defendants' Responses,

[6] In a July 29, 2005 email, Cooper notes that Merrill Pro will begin failing Hazan's trades, and that Hazan understands Merrill Pro will fail his trades. Merrill Pro's stock record shows that the week after this, Hazan's short position in OSTK goes from 4500 shares to 515,000, and continued to be in the high six figures and go over a million shares on occasion for over a year after that point. Jan. 5, 2012 Tr., at 130.

Fact 191. The vast majority of Merrill Pro's fails to deliver in OSTK correspond to Steven Hazan and Scott Arenstein's trading in their Merrill Pro accounts. The trades are identified by looking at Merrill Pro stock records, which show the allocation of the short positions to these two traders – their accounts include "G05" and "AFR"; the stock record shows these traders were short millions of shares, which corresponds closely to the total fails in Merrill Pro's DTCC accounts of millions of shares. Jan. 5, 2012 Tr. at 139-40.

Millions of shares of reported short interest in Overstock were created by the naked short sales that Defendants decided in advance to fail to deliver, and therefore the short seller had no negative rebate cost to factor into its short selling decision. In other words, the naked short sales were not a genuine expression of negative sentiment. However, the market nonetheless perceived those millions of shares as short positions held by short sellers who were incurring that cost and thus had particularly strong negative sentiment. Defendants' Responses, Fact 159. Increasing short interest is considered an indicator to the market of negative sentiment regarding a stock, particularly with a hard-to-borrow stock, where a bona fide short seller has to factor in the steep cost of borrowing in deciding to bet against the stock. *Id.*, Fact 158.

Merrill Pro and GSEC clients were naked short selling Overstock in the form of reverse conversion trades. Defendants' Responses, Fact 182. Hazan and Arenstein's trading strategies were reversals, *i.e.*, reverse conversions. Other clients of Merrill Pro's San Francisco office later became involved in the same type of manipulative conversions. These clients have been identified by Plaintiffs' expert as Susquehanna, Group One and Labranche. Jan. 5, 2012 Tr. at 130-32.

Goldman purchased conversion trades, which were naked short sales, from Hazan and Arenstein, through their entities SBA Trading and Hazan Capital Management.[7] Fourth Amended Complaint, ¶¶ 50, 53. Goldman securities lending personnel purchased conversions. Jan. 5, 2012 Tr. 44:5-18, 48:16-22 (argument by Goldman's counsel). Goldman bought a number of conversion trades in Overstock from Hazan that were specifically identified by Plaintiffs'

[7] Conversions involved the purchase of stock from a counterparty who sold short, combined with options to hedge risk. Cirangle Dec., Ex. C.

expert. These exceeded 350,000 shares. Jan. 5, 2012 Tr. at 139-40. Goldman bought stock from Keystone, a GSEC client, knowing that GSEC would fail to deliver. Jan. 5, 2012 Tr. at 139; Defendants' Response, Fact No. 108. Goldman Sachs as a sophisticated clearing and trading firm must have recognized that the economics of the required short sale component of the conversion be a naked short sale because the pricing can only be explained by the anticipated use of naked short selling, with the knowledge of the seller, Merrill Pro or GSEC (the clearing firm), and Goldman Sachs. Defendants' Response, Fact 187.

The clearing firms, not the clients, determine whether a fail has been resolved and what the age of a fail is ("age" in this context refers to how long the fail has persisted). Defendants' Responses, Fact 177.

Merrill and Goldman also effected fraudulent trades to extend the duration of the fails-to-deliver. These trades allowed Defendants to avoid regulations designed to ensure that fails did not persist past thirteen days after settlement date, without any delivery of stock occurring. Defendants' Responses, Fact 243. Merrill instituted policies to accommodate manipulative trading styles such as "killing" required buy-ins, and providing clients, including Hazan, with information that would enable them to "sell into" buy-ins, resulting in matched trades between Merrill Pro and their clients, which were carried out by the Merrill Pro San Francisco office. Jan. 5, 2012 Tr., at 127. For example, Merrill Pro's Cooper called Hazan the day of buy-ins to tell him the volume to encourage him to sell into the buy in to maintain the fail. *Id.*, at 181.

Hazan, as a result of Merrill working to get Merrill Pro to intentionally fail to deliver his trades and Merrill informing him up front that Merrill would fail all trades, and knowing he could roll the fails longer than 13 days, proceeded to naked short sell millions of shares of OSTK for over a year.[8] Jan. 5, 2012 Tr., at 129. Merrill provided Hazan with regulatory advice regarding RegSHO and reset transactions, and an internal Merrill Pro email

[8] Hazan's account was based in Merrill Pro's San Francisco office, and the head of the San Francisco office, Alan Cooper, was Hazan's primary point person at Merrill Pro and communicated with Hazan five to six times a week. Cooper worked so closely with Hazan that he jokingly referred to him as his "boyfriend" in internal Merrill Pro emails. Jan. 5, 2012 Tr., at 125-26.

notes that Cooper's Merrill Pro traders "were knowingly putting on shorts and then basically rolling them every 13 days," Jan. 5, 2012 Tr., at 126, 128.

Likewise, Goldman encouraged and participated in sham close-outs of fails to deliver. GSEC would nominally "buy-in" clients, but GSEC would assist its clients (including Keystone and Wolverine Trading) in entering into sales that offset GSEC's purchases, again, a form of matched orders. Selling into buy-in negates the economic substance of the buy-in. Defendants' Responses, Fact 181, Jan. 5, 2012 Tr., 59:16-60:5, 61:24-28. These transactions would be understood in the securities industry to constitute "matched orders." These matched orders had the effect of maintaining GSEC's fails to deliver. In August 2006, GSEC had a huge fail-to-deliver position at CNS of approximately a million shares. Defendants' Responses, Fact 181.

Through their actions, Defendants artificially inflated short interest in Overstock in 2005 and 2006 to extraordinary levels. Defendants' fails-to-deliver in Overstock were so large and persistent that Overstock was on the "Threshold Securities List" for 667 consecutive trading days—nearly three straight years, every single trading day. Overstock was one of only two Nasdaq stocks to have fails that persistent. Defendants' Responses, Fact 147. A May 5, 2006 email from a GSEC employee to an employee in the Goldman Sachs Securities Lending Group stated that GSEC had "noticed fails going up rather dramatically over the last few months at GSEC" (email forwarded to James Dengler). *Id.*, Fact 225. A May 2006 internal Goldman email notes that "Two months ago 107% of the floating was short!", referring to the short interest in Overstock as a percentage of float. In May 2006, Goldman Sachs' research department report distributed to clients shows Overstock as the fourth-highest shorted stock for all stocks under $1 billion in market capitalization. *Id.*, Fact 163.

The naked short selling resulted in short positions on Defendants' books and records, even though Defendants had never borrowed stock and made delivery to settle the short position. Defendants' Responses, Fact 152. This artificially high short interest caused by the naked short selling was reported to the marketplace as bona fide short interest. *Id.*, Fact 153. Defendants' actions injected false information into the marketplace for Overstock securities in the

form of artificially high short interest figures for Overstock stock so that market participants would be induced to view the stock more negatively, creating downward price pressure on the stock. With high negative rebate stocks such as Overstock, the short interest is additionally signaling not only a negative sentiment, but one that is so strong the short seller is wiling to bet against the stock at a cost of whatever the negative rebate is. For example, where Overstock's negative rebate was 35%, a legitimate short seller was betting the stock will drop enough to cover his 35% cost and then make an additional profit after that. Here, millions of shares of reported short interest in Overstock was created by the naked short sales that Defendants decided in advance to fail to deliver, and therefore the short seller had no negative rebate cost to factor into its short selling decision. In other words, the naked short sales were not a genuine expression of negative sentiment. However, the market nonetheless perceived those millions of shares as short positions held by short sellers who were incurring that cost and thus had particularly strong negative sentiment. *Id.*, Fact 159.

Merrill made delivery of stock the first half of 2005 and recognized that it would violate federal law not to do so. Jan. 5, 2012 Tr., at 181.

Merrill Pro's Chief Compliance Officer was adamantly opposed to the scheme. Defendants' Responses, Fact 229. A Merrill email refers to "F* compliance" in response to Merrill's manually failing the first trade for Hazan from San Francisco. Jan. 5, 2012 Tr., at 181. Defendants lied to regulators about their fails to deliver. Defendants' Responses, Fact 174. Goldman Sachs also sought to conceal evidence of how fails occurred and might be linked to trades. *Id.*, Facts 238-39.

Defendants were members of an industry group that expressly referred to Overstock as an "enemy" and discussed "neutralizing" a potential Overstock expert witness in this case. An email from the Securities Industry and Financial Markets Association ("SIFMA") refers to efforts to prevent a potential expert from working with Overstock and goes on to state that the expert "should be someone we can work with, especially if he sees that cooperation results in resources, both data and funding; while resistance results in isolation." Defendants' Responses, Fact 244. When Overstock obtained passage of a law that would require disclosure of

clearing firms' fails-to-deliver (which is kept secret from the public), the Goldman Defendants gloated when their lobbying organization got the law overturned, with one person remarking that Goldman was seeing a return on its lobbying investment. *Id.*, Fact 245.

Much of this information was also contained in the Proposed Fifth Amended Complaint that the Court did not allow Plaintiffs to file. The proposed complaint refers to and quotes from discovery material, and the complaint also makes reference to a non-public SEC investigation. July 27, 2011 Tr., at 31.

B. Facts Made Public in the Nine Regulatory Orders For the Scheme Published to Date

This scheme so far has resulted in at least eight public sanctions orders against various traders, for both their role in selling the conversions to prime brokers, as well as their role in the fails, sham flex resets and selling into the buy-in when RegSHO buy-ins occurred—plus one recent new order instituting proceedings. *See* Cirangle Dec., Exs. C-J (sanctions orders against Scott Arenstein, Steven Hazan, Brian Arenstein, Group One Trading, Labranche, Keystone, Woverine) and Ex. K (Order Instituting Proceedings against Jeffrey and Robert Wolfson ("Wolfson Order")).

These nine orders all concern the precise trading that was part of the Defendants' scheme in this case. The demand for the naked short sales was driven by Goldman Defendants' desire to obtain supply of hard to borrow stock where no legitimate supply existed. The scheme required the clearing firms to set up their systems and procedures to intentionally fail the trades and to allow the fails to persist for the length of time the manipulated supply of stock was needed to support short sales. These nine orders reflect the actions of the traders in the scheme. These publicly available orders also provide significant additional detail regarding the scheme, including in-depth descriptions of the purposes of the scheme, the details of the trading, and the identification of various clearing firm policies and procedures that were part of the scheme.

For example, the January 31, 2012 Wolfson Order contains 22 pages of details of the trading scheme. Jeffrey Wolfson founded Pax Clearing Corporation which Merrill Lynch Professional Clearing Corp. purchased in April 2005. Cirangle Dec., Ex. K at p. 7, ¶ 21. The

Wolfson Order explains how Wolfson, his brother and others, proceeded to naked short sell 491 reverse conversions to prime brokers, details the precise trading methodology, gives examples of how the reversals worked, including pricing and the illicit profits made from the scheme, and how it worked on their clearing firms' books and records. *Id.*, p. 8-9, 13, ¶¶ 29, 30 42, 44.

The Wolfson Order explains that the conversions were purchased by prime brokers, who purchased the non-existent shares in order to acquire a long stock position that the prime broker could loan out, and receive significant fees from the borrowers. Cirangle Dec., Ex. K at pp. 3-4. In one example, the prime brokers would pay an implied borrow rate of 20% for the long stock it "purchased" from Wolfson, and then the prime broker would charge its hedge fund customers 30% to borrow the non-existent stock. *Id.* at p. 12, ¶40. In many cases, these conversions the prime brokers purchased were in stock that could not be borrowed at all. *Id.* at p. 4. When the traders sold the stock to the prime brokers, the stock was not borrowed and delivery never made on these sales. Thus, the traders did not have to factor in the cost to borrow stock when they quoted the conversions to the prime broker, which is why they could sell stock no one else had and below cost. *Id.* at pp. 12-13.

The Wolfson Order also details the sham flex reset transactions used to extend the fails, explaining the purpose was to reset the Reg SHO clock at the clearing firm without any stock ever being delivered. The Order details exactly how the trades worked, the effect on the clearing firm's books, and the profit formula of .03 cents per share that was common to these sham transactions. Cirangle Dec., Ex. K at pp. 4-5.

Likewise, the Hazan and Arenstein Orders detail the same exact scheme. These orders explain how "prime brokers created the demand for the reverse conversion to create inventory for stock loans on hard to borrow securities" and how Hazan, among others, fed this demand. Cirangle Dec., Ex. E ("Hazan SEC Order"). The Hazan SEC Order details the conversion trades and the flex reset "sham" transactions, including precise trading strategies, examples of trades, the illicit profits reaped from the trades, and how this trading resulted in large fails on the clearing firm books. The AMEX/ARCA Order against Hazan also discusses his purported "market making" on the Pacific Exchange/Arca in detail. Cirangle Dec., Ex. D. The

Arenstein AMEX Order, contains the same detail as the Hazan Orders. *Id.*, Ex. C. Collectively these orders fine Hazan and Arenstein $10 million and ban them from the industry for a minimum of five years.

Other Merrill Pro customers Labranche, Group One, and Brian Arenstein have also been sanctioned for the same trading strategies, which are likewise described in the public sanctions orders. Cirangle Dec., Exs. F-H. Goldman customers Wolverine Trading, LLC and Keystone Trading Partners were publicly sanctioned for sham reset transactions. Cirangle Dec., Exs. I, J. The Keystone Order also describes 51 situations where, on the very same day they had been bought-in by their clearing firm, they sold into the buy-in. *Id.*, Ex. I.

C. Facts Defendants Improperly Seek to Seal

The documents, testimony and pleadings Defendants seek to seal in this case all concern the same scheme described above. Despite the fact that a) the vast majority of the information Defendants seek to seal is already in the public record, either through publicly available filings or transcripts in this case, or through the eight public sanctions orders against the various traders for the scheme, b) all of the policies and procedures that are discussed in the documents are outdated and could never be revived given the strengthening of federal law geared specifically to eliminating the ongoing fails that still persisted due to Defendants' policies that created fails, (*see, e.g.*, Cirangle Dec., Exs. L and M (Melz and Mastrianni testimony confirming Merrill's Reg SHO policies changed in 2008 when the rule changed)), c) the vast majority of the customer trading information Defendants seek to protect concerns the illegal trades that Defendants' customers have been publicly sanctioned for, and d) any other confidential customer information could easily be redacted to protect any legitimate remaining privacy concerns, ***Defendants still seek to seal the entirety of virtually every single evidentiary document*** submitted by the Plaintiffs in opposition to Defendants' motions for summary judgment.

For example, Defendants' counsel publicly stated:"[I]t was common knowledge in the marketplace that Merrill Pro and GSEC were not borrowing shares for market-maker trades because we were doing it for all of our market-maker customers. It wasn't just for Hazen [sic]." Jan. 5, 2012 Tr., at 23:21-24. Defendants' counsel further emphasized that "this case is about

firmwide policies by Merrill Pro and GSEC to fail the short—the short sales of our market-maker clients." *Id.* at 167:7-10. Yet Defendants seek to seal six to seven year-old emails discussing this very subject. Examples include a series of emails from 2005, where Merrill executives discuss the possibility of failing market maker negative rebate stocks:

- In a half-page email, a Merrill executive suggests "[w]e might want to consider allowing Sage customers to fail." Thomas Tranfaglia, Merrill Pro's then President responds "[y]es, we are going to look into that." Exhibit 6 to Cirangle MSJ Decl.[9]

- In a half-page email Merrill's CEO, John Brown, says "I understand that we have the same issue with 369 that we had with 551 market makers. How and when can we prevent the delivery?" and Tranfaglia responds "[s]top borrowing for the market-makers!" Exhibit 7 to Cirangle MSJ Decl.

- In a two-line email Brown writes his secretary: "I have a meeting at 2 with Tom T, tell him I want an update on how we're going to fix fails and I want to know what we nees [sic] to do to make 369 market makers fail." Exhibit 12 to Cirangle MSJ Decl.

- In June 2005 Tranfaglia emails "We are NOT borrowing negatives…I have made that clear from the beginning. Why would we have to borrow them? We want to fail on them", and in a June 2006 email, Tranfaglia states "We don't deliver mm negatives, has nothing to do with availability." Exhibits 41, 112 to Cirangle MSJ Decl.

- A one page 2005 compliance procedure notes that Merrill will not borrow securities for delivery on market maker deep negative rate securities. Exhibit 147 to Cirangle MSJ Decl.

- In an internal email exchange at the time Scott Arenstein was looking to change clearing firms and inquiring about Merrill's policies, Tranfaglia notes in reference to Arenstein "he wants to short and have us fail on the negatives, correct?" Another Merrill executive, Curt Richmond, responds "Yes…He is a market maker/floor trader on the AMEX." Exhibit 27 to Cirangle MSJ Decl.

- An email from Alan Cooper notes, in regard to Steven Hazan: "Steve understands that 671 will fail on negatives;" and in a follow up email Cooper notes "I think the transfer will affect his shorts. We borrowed all of these and will start failing at PAX." Exhibits 47, 49 to Cirangle MSJ Decl.

Given that it was "common knowledge" and a publicly disclosed "firmwide policy" of Merrill's " to fail short sales of market maker clients," these documents discussing and

[9] All of these references are to the original declarations filed in support of Plaintiffs' opposition to summary judgment. Additional courtesy copies of the cited documents, along with a few other similar examples, are provided in Exhibits Q (Merrill Defendants' documents) and R (Goldman Defendants' documents) to the Cirangle Declaration filed in opposition to the current motion.

reflecting that very policy are not trade secrets.[10]

Likewise, Goldman Defendants seek to seal emails reflecting their firm-wide policy to fail short sales of their market maker clients by withholding inventory for settlement:

- Ex. 7 to Sommer MSJ Decl.: This email informs GSEC's largest client, Wolverine Trading, that "we will let you fail," in response to an inquiry by Wolverine as to whether there was some effort "at cleaning up" fails.
- Ex. 43 to Sommer MSJ Decl.: This email refers to a senior GSEC executive, Peter Lawler, "really backing down from 'turning on neg[ative] rates on 1/26' and cleaning up fails."
- Ex. 47 to Sommer MSJ Decl.: This email refers to Arenstein having a "0% floor" for conversions, meaning that Arenstein will not pay to borrow the stock when selling a conversion to Goldman Sachs.
- Ex. 115 to Sommer MSJ Decl.: This email refers to "fails going up rather dramatically over the last few months at GSEC," followed by another email concluding that most of the fails are for stocks that are illiquid or "trading at negative rebate with non-paying customers."

Defendants seek to seal multiple emails and other documents concerning Hazan and Arenstein's Merrill Pro and GSEC accounts and their trading, despite the fact that this exact trading was both illegal and publicly detailed in the various sanctions orders. Examples include:

- A March 2005 internal Merrill email discusses Arenstein's "Reg-SHO fail with FLEX Options Strategy." Ex. 28 Cirangle MSJ Decl.
- An August 2007 email between a Merrill employee and a Goldman employee forwards the Arenstein sanctions order and the Merrill employee notes "I am sure you saw this. Our boy" and the Goldman employee responds "nice...You think there will be any fallout on clearing firms?" Ex. 144 Cirangle MSJ Decl.
- A January 2006 telephone transcript reflects a discussion between Merrill's compliance officer and another employee regarding the fact Arenstein is not making a market in OSTK, that he keeps "recycling" his short sales in ten to fifteen stocks and that this is "not okay." Ex. 94 Cirangle MSJ Decl.

[10] Defendants argue that although certain facts are in the public record, documents should still be sealed because they may reflect more detail about what is publicly available. *See* Merrill Defendants' Brief at p. 9, n. 6. Of course, Defendants make no effort to show that any of the documents they seek to seal actually have the kind of additional detail that reveals "internal strategic thinking" about otherwise publicly-known policies and procedures that qualifies for sealing. Most of these emails, such as the examples cited, simply reflect the fact that Defendants decided to stop borrowing and intentionally fail to deliver market maker negative rebate stocks, and/or that they did so through the methods already publicly discussed, such as the "do-not-flip" process at Merrill or by Goldman Sachs withholding inventory from GSEC to settle the trades. Defendants have made no showing as to what additional competitive disadvantage they would suffer from these discussions of procedures that they claim were common knowledge in the marketplace.

- Various spreadsheets and stock records reflect the naked short sales and sham flex reset trades in OSTK that Hazan and Arenstein were sanctioned for. See, e.g., Allaire Decl., Exs. C1-12, 19, Exs. 160, 161, 166, 167 Cirangle MSJ Decl.

- An August 2005 email reflects Cooper's statement that Hazan questioned "why Merrill did not tell him that we did not like his trading Reg Sho issues with flex's [sic]. He said he would have stopped if he knew Merrill was opposed to it." Ex. 119 Cirangle MSJ Decl.

Goldman Defendants seek to seal documents that reflect their strategy of purchasing conversions from market makers like Hazan and Arenstein in order to create inventory for stock lending at below market rates, despite the fact that this "strategy" is a matter of public knowledge. Moreover, such conversion trades with naked short sellers are presumably not a current practice at Goldman given the sanctions orders against Hazan and Arenstein, as well as regulatory changes that put in place new hurdles for trading strategies tied to abusive, persistent fails. Examples of documents Goldman seeks to seal include:

- Ex. 4 to Sommer MSJ Decl.: This internal GSEC email refers to Scott Arenstein and his entity, SBA Trading, "providing very aggressive liquidity to Goldman" in the form of conversion trades with Goldman Sachs' securities lending group. A senior GSEC executive observes that "that doesn't make sense" [because a naked short seller like Arenstein had no actual stock to sell to a securities lending desk];

- Exs. 8 and 53 to Sommer MSJ Decl.: Ex. 8 is an email from a senior GSEC executive refer to Arenstein carrying "large shorts in symbols that everyone on the street is failing"; Ex. 53 is an email that shows that SBA Trading's positions represent roughly $7.8 billion of $13.3 billion of market values of market maker positions in stocks that are negative rebate stocks, including hard-to-borrow stocks (meaning they do not pay a positive rebate like the vast majority of stocks);

- Exs. 17-20 to Sommer MSJ Decl.: These emails refer to a meeting between a team of Goldman Sachs executives and Arenstein in a bar named Ulysses on August 16, 2004. In Exhibit 17, William Conley, the second-in-command and later head of Goldman Sachs' securities lending group, inquires of a senior GSEC executive about Arenstein, who Conley characterizes as being "the other side of a lot of our activity." In Exhibit 18, the GSEC executive, Peter Lawler, informs Conley that he doubts Arenstein will trade once Reg SHO comes into effect "as he will not be able to fail anymore" and that he will be "out of this business come January." As shown in Exhibits 18 and 19, Conley nonetheless proceeds to meet with Arenstein, and, as shown in Exhibit 20, Conley and his team are exploring trades with Arenstein on August 19, 2004. The fact that Conley, Rosenbloom and Santina of Goldman Sachs met with someone at Ulysses on August 16, 2004 and exchanged emails regarding the meeting is already in public record. (Defs. Responses p. 80, Fact 216);

- Exs. 63 and 89 to Sommer MSJ Decl.: Ex. 63 is a list of compliance bullet points that refers to using conversions to "create inventory to allow customers to short."; Ex. 89 is an email that refers to Goldman Sachs "intentions to create supply and perpetuate selling in stocks with a large amount of short interest."

- Ex. 86 to Sommer MSJ Decl.: This worksheet analyzed conversions purchased by the Goldman Sachs securities lending group for October 2005 and finds that Arenstein sold 63% of the shares to Goldman Sachs.

- Ex. 155 to Sommer MSJ Decl.: In this email, a GSEC executive refers to Keystone as being "Scott Arenstein all over again";

- Ex. 228 to Sommer MSJ Decl.: This June 6, 2005 letter terminated Arenstein as a GSEC client, but, as shown above, Goldman Sachs continued its special trading relationship with Arenstein post-termination.

Defendants also seek to seal a series of documents that indisputably do not contain any trade secrets or otherwise confidential information, but are simply embarrassing to Defendants because they reflect business decisions to put profits and corporate ambition over compliance. Examples include:

- In a May 2005 email string, Messinger expresses concern that Cooper has intentionally failed a short sale for Hazan. In response, Melz, Merrill Pro's President, emails: "Fuck the compliance area – procedures, schmecedures." Ex. 39 Cirangle MSJ Decl. Melz previously swore to this Court that his quoted statement was "a joke", but now swears it is a trade secret. Cirangle Decl, Ex. N.

- In various internal Merrill emails, Messinger expresses repeated concern that the fails to deliver are improper. See, e.g. Ex. 112 to Cirangle MSJ Decl., "As far as I'm concerned, this is totally unacceptable – we are failing when we have over a million shares of stock available...Is there a blanket agreement that we allow every market maker client to continue failing even if there is enough availability? In my opinion, there needs to be some assessment done here, and fails cleaned up regardless of who is causing them."

- In other internal Merrill emails, other Merrill employees recognize that it would be illegal to fail the trades: *See, e.g.*, Ex. 33 to Cirangle MSJ Decl., where, in a discussion about whether they should fail the market maker trades, Brown notes that "[t]he intent of SHO is to clean up Threshold securities which should include an economic incentive to clean it up...I think we can not give them a choice."; *Id.* at Ex. 19, an email authored by Melz where he states "RegSHO...mandates delivery of certain 'threshold' securities if available."; *Id.* at Ex. 15, an email where Richmond states "Scott Arenstein...also wants to trade hard-to-borrow securities and not be charged a negative...I will tell Arenstein that he can't trade these" and "If Merrill Lynch has to borrow according to Reg-SHO then clients have to pay the negatives. We must be within the rules and we must pass these negs to the clients."

- A September 2006 telephone transcript between Merrill executive Collin Carrico and a client contains a discussion by Carrico about how a trader could do non-market making trades within a market making account, which is illegal,

but would never get caught, and discusses strategies to carry out this illegal activity. Ex. 121 Cirangle MSJ Decl. Carrico also discusses in a July 2007 email how Merrill's balances have been seriously impacted after Wolfson and his buddies "minimized their Reg SHO trading activity given the heightened regulatory risk environment." *Id.* Ex. 140.

- Exhibit 110 to Cirangle MSJ Decl. is a presentation Merrill gave to regulators regarding its Reg SHO tracking system. The key point in this document is that Merrill says in multiple places its system requires "delivery" of stock. Messinger testified that this was false – their system did not require delivery. Cirangle Dec., Ex. 0. Obviously a false statement about internal systems cannot reflect any trade secret.

- Ex. 96 to Sommer MSJ Decl. is an email from John Masterson that sends nonpublic data concerning customer short positions in Overstock and four other hard-to-borrow stocks to Maverick Capital, a large hedge fund that sells stocks short.

- Ex. 123 to Sommer MSJ Decl.: This email from a GSEC executive exclaims that short sales amount to 107% of the float of Overstock.

- Ex. 167: In this email, a Goldman Sachs executive states: "[P]er Les Nelson, we have to be careful not to link locates to fails [because] we have told the regulators we can't."

- Ex. 177 to Sommer MSJ Decl.: In this email chain, a SIFMA lobbyist emails a Goldman Sachs executive and explains how to engage an expert that would otherwise work for "our more powerful enemies," meaning Overstock: "[H]e should be someone we can work with, especially if he sees that cooperation results in resources, both data and funding; while resistance results in isolation."

- Ex. 193 to Sommer MSJ Decl.: In this email, as disclosed in Defendants' Responses, Fact 161, a Goldman Sachs hedge fund client remarked on how they would ask "to short an impossible name and expecting full well not to receive it) and [be] shocked to learn that [Goldman's representative] can get it for us." The contents of the email are in Defendants Responses, but Goldman Sachs does not want the document to be public so that there will be an actual document that can be viewed, not just a legal brief.

Defendants also seek to seal graphs and testimony regarding the volume of their fails to deliver in Overstock stock from 2004 to 2007, despite the fact that the general volume of these fails is publicly known, and the data is years old. See, e.g., Ex. 159 Cirangle MSJ Decl.

These documents are just a handful of the hundreds of documents Defendants seek to seal, and there are countless additional examples of how these documents do not contain

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information that qualifies for the "extraordinary" measure of sealing. None of the documents involve any legitimate, current confidentiality interest of Defendants or their clients. There is no way Plaintiffs can, in the limited time and space allowed for this brief, point out all of the problems with each document, nor is it Plaintiffs' burden to do so.

D. Facts Where No Confidentiality Designation Was Made

1. Cohodes Testimony

Goldman improperly seeks to seal the testimony of Marc Cohodes, the managing partner of one of its largest short-selling clients, Copper River Partners. However, no person, including Goldman, Mr. Cohodes, or their counsel, designated the Cohodes transcript as confidential. Under Section 4 of the Stipulated Protective Order, a deposition transcript is designated as confidential "either during the deposition or by written notice to the court reporter and all counsel of record... ." The transcript was not designated by any person as confidential during the deposition nor was it designated by written notice to the court reporter. *See* Declaration of Jonathan Sommer in Support of Plaintiffs' Consolidated Opposition to Defendants' Motion to Seal Summary Judgment Papers, ¶ 2.

In spite of the lack of confidentiality designation, Goldman wants to keep the Cohodes transcript nonpublic because of potential embarrassment, including testimony such as the following:

> Q. Well, do you know how -- do you have any view as to whether the securities lending market is actually efficient or inefficient?
>
> A. I think the securities lending market is just like the mob. I think it's completely rigged. It's a completely manipulated black hole, non-transparent market.
>
> Q. Now, when you say you think they're just like the mob, are you referring to Goldman Sachs?
>
> A. Yes. I think Goldman Sachs is like the mob.
>
> Q. And are you referring to them in particular or them and the rest of the market altogether?

> A. I think Goldman Sachs is a racketeering entity that does whatever they can to make a dime without conscience, thought, foresight or care about ramifications. I think they are cold-blooded and could care less about the law. That's my opinion. I think I can back it up.

Ex. A to Sommer Decl., at 144. Its failure to designate the transcript ends the issue.

2. Power Point Presentations at Summary Judgment Hearing

In asserting confidentiality claims, Defendants also ignore the fact that at the hearing on summary judgment, Plaintiffs presented Power Point presentations that were projected on a large screen while members of the public, including the press, were present. These presentations further detailed facts of the scheme the Defendants now claim must be sealed in order to protect trade secrets or confidential information, including exact quotes from many of the same documents Defendants now seek to seal. Defendants did not object at the time and did not move to seal the courtroom or otherwise disallow anyone to view these details. The Power Point presentations further show that disclosure of these facts is not prejudicial to Defendants, as they have identified no prejudice arising from the disclosures at the hearing.[11]

III. ARGUMENT

A. The Sealing Rules Apply to All of the Documents Submitted as Part of the Summary Judgment Motion.

"Rules 2.550-2.551 apply to records sealed or proposed to be sealed by court order." Cal. R. Ct. 2.550(a)(1). Here, Defendants seek to seal the summary judgment records; therefore, Rules 2.550-2.551 apply. The Stipulated Protective Order expressly subjects the sealing of records to the analysis required by California Rules of Court 2.550-2.551, and the parties knew that any sealing of records for dispositive motions was subject to the standards therein. In other words, Defendants understood, and the rules required, that any designation of a document as "confidential" was only for discovery purposes and that, upon the filing of a non-

[11] An extra copy of these presentations is attached as Ex. P to the Cirangle Declaration in support of this opposition. Plaintiffs have filed these presentations under seal not because they believe that there is any basis to seal them, but rather as a courtesy to allow the Court to first confirm that, given the public presentation, the additional copies of these documents cannot be sealed.

discovery motion, a party would have to meet the standard for the sealing of the records, as applied by the Court. Rules 2.550-2.551 forbid sealing documents upon the parties' stipulation. *H.B. Fuller Co. v. Doe*, 151 Cal. App. 4th 879, 891 (2007).[12]

The sealing rules were adopted to comply with the California Supreme Court's decision in *NBC Subsidiary. In re Providian Credit Card Cases*, 96 Cal. App. 4th 292, 298 (2002). In *NBC Subsidiary*, the California Supreme Court held that the First Amendment right of access applies to civil proceedings. *NBC Subsidiary, Inc. v. Superior Ct.*, 20 Cal. 4th 1178, 1209 (1999). In reaching that holding, the Court reviewed case law concerning access to judicial records in addition to case law concerning access to trials:

> Numerous reviewing courts likewise have found a **First Amendment right of access to civil litigation documents filed in court as a basis for adjudication.** (See *Brown & Williamson Tobacco Corp. v. F.T.C.* (6th Cir.1983) 710 F.2d 1165, 1179 (*Brown & Williamson*) [documents **filed** in civil litigation; "[i]n either the civil or criminal courtroom, secrecy insulates the participants, masking impropriety, obscuring incompetence, and concealing corruption"]; *Rushford v. New Yorker Magazine, Inc.* (4th Cir.1988) 846 F.2d 249 (*Rushford*) [**summary judgment pleadings**]; *Matter of Contintental Illinois Securities Litigation* (7th Cir.1984) 732 F.2d 1302 (*Continental Illinois Securities*) [**records related to "hybrid summary judgment motion"**]; cf. *Grove Fresh Distributors, Inc. v. Everfresh Juice Co.* (7th Cir. 1994) 24 F.3d 893 [assuming both a First Amendment and a common law right of access to civil litigation documents].)
>
> ****
>
> By contrast, decisions have held that the First Amendment does not compel public access to discovery materials that are neither used at trial nor **submitted** as a basis for adjudication. [citations omitted]

NBC Subsidiary, 20 Cal. 4th at 1208-09 n. 25 (emphasis added).

In an opinion published shortly after *NBC Subsidiary*, the Ninth Circuit likewise

[12] It is irrelevant that documents were previously designated as confidential and lodged under seal. *See, e.g., Foltz v. State Farm Auto Ins. Co.*, 331 F.3d 1122, 1136 (9th Cir. 2003). The procedures for allowing a party to designate a document as confidential are inapplicable to the sealing determination because only the Court can determine whether a record may be sealed, not the parties by private agreement. Moreover, while paragraph 18 allowed Plaintiffs to file motions seriatim to challenge confidentiality designations, that procedure extended to all discovery—not just the limited discovery submitted in connection with the motion for summary judgment. Nothing in paragraph 18 required Plaintiffs to challenge a designation through the procedures set forth in that paragraph, and filing such motions would have consumed the Court's and Plaintiffs' resources unnecessarily because there were hundreds of thousands of documents to wade through. It is far more efficient to await the identification of the much more limited material in the summary judgment motion before spending time and money examining whether those important records were properly designated.

found that the public's right of access "extends to materials submitted in connection with motions for summary judgment in civil cases... ." *San Jose Mercury News, Inc. v. District Ct.*, 187 F. 3d 1096, 1102 (9th Cir. 1999) (emphasis added).

Summary judgment "serves as a substitute for trial," "stands on a wholly different footing" than mere discovery and is subject to the heightened First Amendment standard for sealing. *Rushford v. New Yorker Magazine*, 846 F. 2d 249, 252-53 (4th Cir. 1988) (cited in *NBC Subsidiary*, see block quotation above). The Sixth Circuit summarized policy considerations from the United States Supreme Court precedent that underlie the public right of access in civil cases: First, "[t]he crucial prophylactic aspects of the administration of justice cannot function in the dark; no community catharsis can occur if justice is 'done in a corner [or] in any covert manner.'" Second, "public access provides a check on courts. Judges know that they will continue to be held responsible by the public for their rulings. Without access to the proceedings, the public cannot analyze and critique the reasoning of the court." Third, open courts promote "true and accurate fact finding" because the dissemination of information to the public through the media may cause additional witnesses to come forward and will cause existing witnesses to testify more truthfully. *Brown & Williamson Tobacco Corp. v. F.T.C.*, 710 F.2d 1165, 1178 (6th Cir. 1983) (cited in *NBC Subsidiary*, see block quotation above); *see also H.B. Fuller Co. v. Doe*, 151 Cal. App. 4th 879, 894 (2007) ("The deeper the public's understanding of judicial treatment of these issues, the better equipped the public will be to, for instance, seek legislative modification of the governing rules and procedures"). Applying this reasoning here, it is imperative for the Court not to seal Defendants' records where summary judgment is entered in favor of the Defendants and there will be no future exposure of Defendants' conduct at trial.

Defendants ignore the controlling authority above and instead try to misapply *Mercury Interactive*—which had nothing to do with summary judgment or dispositive motions—to create the following purported standard: "[M]aterials obtained through discovery must be considered or relied upon by the Court as a basis of adjudication before the presumption of public

access can even be invoked by a party seeking to make such documents public."[13] Goldman Motion, at 7. Nothing in Rules 2.550-2.551 requires an "invocation" by the non-sealing party, and Defendants offer no definition of what it means to "consider or rely upon" a document as a basis of adjudication. Nothing in Rules 2.550-2.551 refers to the Court having to "consider" or "rely" upon a document, nor does the case law. As shown above, the sealing records apply to all documents "submitted as a basis for adjudication," and *NBC Subsidiary* relied on cases that review all documents "filed," *i.e.*, submitted, in connection with a summary judgment motion. *See NBC Subsidiary*, 20 Cal. 4th at 1208-1209 n. 25; *see also Republic of the Philippines v. Westinghouse Elec. Corp.*, 949 F.2d 653, 660 (3d Cir. 1991) (holding that party moving for summary judgment could not avoid the public right of access simply because the motion was denied (and thus the court did not rely on any documents filed by the moving party)). In sum, no California law requires a Court to parse out exactly which documents were purportedly "considered" or "relied upon" as a basis for its adjudication.

Nor would it be practical for the Court to try to determine what it "considered" or "relied upon" as a basis for adjudication. In essence, the Court's holding is that insufficient wrongful conduct occurred in California. In reaching that determination, the Court should have considered all of the evidence submitted as part of the summary judgment papers. It would be erroneous for the Court to disregard any evidence of wrongful conduct. Thus, there is no practical means for the Court to parse out evidence as being evidence of wrongful conduct not considered in connection with summary judgment. And, if the Court failed to consider such evidence, its failure to consider evidence should be specified in the order granting summary judgment so that the Court of Appeal will know what summary judgment evidence was not considered by the Court.

Finally, Defendants cannot complain that Plaintiffs purportedly submitted too much evidence as a basis for adjudication and, on that basis, ask the Court to withhold the evidence from the public. In their summary judgment motions, Defendants raised 38 purportedly

[13] Of course, Defendants are "seeking" to withhold documents from the public and bear the burden of proof, and Defendants cannot escape that burden by using linguistic tricks such as referring to Plaintiffs as "seeking" to make documents public.

dispositive issues which made a wide range of arguments concerning whether Defendants engaged in market manipulation, whether Defendants acted with fraudulent intent, whether the manipulative conduct occurred in California, etc. In response to the 38 summary judgment issues, Plaintiffs submitted evidence in the form of two declarations from counsel that attached deposition exhibits and testimony, as well as seven expert declarations. The combined number of exhibits totaled less than 500 in response, or less than 0.0009 percent of the documents produced by Defendants. Cirangle Dec., ¶23. Those exhibits were also referred to in the summary judgment pleadings.[14]

Based on the Court's ruling that there was insufficient evidence of actionable conduct in California, Plaintiffs were, if anything, prejudiced by not putting in enough evidence in response to summary judgment issues directed to that point. Of course, Plaintiffs had no way of knowing which of the 38 issues would ultimately become the focus of the Court's interest and had to put in evidence on all of the issues.[15] Much of that evidence is overlapping and indistinguishable, *e.g.*, evidence of manipulative conduct would be relevant both to the issue of whether manipulative conduct occurred and whether that manipulative conduct occurred in California. Indeed, all evidence of wrongful conduct, which is essentially all of the evidence submitted by Plaintiffs in the declarations from experts and counsel, is relevant to determining

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[14] Defendants claim that some of the exhibits to the Cirangle and Sommer Declarations filed in support of their opposition to the Motion for Summary Judgment were not cited in Plaintiffs' Separate Statement. That is false. Plaintiffs cited all these exhibits in Plaintiffs' Separate Statements, either in response to individual specific facts or in response to Defendants' facts that encompassed Section 25400 or the UCL. See, e.g., Plaintiffs' Separate Statement of Disputed and Undisputed Facts in Opposition to Merrill Lynch Professional Clearing Corp.'s Motion for Summary Judgment, at p. 60, Fact 48 (Section 25400 Claim), p. 75, Fact 91 (UCL Claim); Plaintiffs' Separate Statement of Disputed and Undisputed Facts in Opposition to Merrill Lynch Pierce Fenner & Smith's Motion for Summary Judgment at p. 38, Fact 39 (Section 25400 Claim); p. 48, Fact 65 (UCL Claim); Plaintiffs' Separate Statement of Disputed and Undisputed Facts in Opposition to Goldman Sachs Execution & Clearing, L.P.'s Motion for Summary Judgment at pp. 14-15, Fact 30 (Section 25400 Claim), and pp. 58-59, Fact 92 (UCL Claim); Plaintiffs' Separate Statement of Disputed and Undisputed Facts in Opposition to Goldman Sachs & Co's Motion for Summary Judgment at p. 36, Fact 25 (Section 25400), at 100, Fact 89 (UCL Claim).

[15] Indeed, the Court repeatedly told the parties that Plaintiffs had raised material issues of fact as to whether Defendants' conduct constituted manipulation and as to whether Defendants had the requisite intent to manipulate the market. The fact that the Court did not grant the motion for summary judgment on any of these alternative grounds is in and of itself a determination by the Court on summary judgment.

whether wrongful conduct occurred in California.

Accordingly, the sealing rules set forth in Rules 2.550 and 2.551 apply to each document Defendants seek to seal in their current motion.

B. <u>For each document, Defendants have not met the five-part test set forth in Rule 2.550(d).</u>

Defendants have the burden—on a document-by-document basis—of enumerating specific facts satisfying the test for sealing records (whether pleadings or exhibits). For each record Defendants seek to shield from the public, Defendants must introduce evidence sufficient for the Court to make "express factual findings" establishing: (1) there exists an overriding interest that overcomes the right of public access to the record; (2) the overriding interest supports sealing the record; (3) a substantial probability exists that the overriding interest will be prejudiced if the record is not sealed; (4) the proposed sealing is narrowly tailored; and (5) no less restrictive means exist to achieve the overriding interest. Cal. R. Ct. 2.550(d)(1)-(5). As set forth in the rule itself, these five express factual findings must be made for each record to be sealed.

1. For each document, Defendants have failed to establish an interest that overrides the strong presumption of public access and that supports sealing the record.

Whereas an order unsealing records does not require any specific factual findings, an order sealing records requires specific factual findings for each record that justifies the sealing of the record in question. *Providian*, 96 Cal. App. 4th at 302. In light of the First Amendment issues involved, that distinction in the California Rules of Court is "not at all surprising." *Id.*

In order to seal the exhibits and summary judgment pleadings that reference those exhibits, it is Defendants' burden to prove the existence of trade secrets to establish the interest that overrides the right of public access. *Providian*, 96 Cal. App. 4th at 301.[16] If a trial court finds

[16] Defendants also argue that even if their documents do not contain trade secrets, they can be sealed if they contain "confidential internal business information." See, e.g., Merrill Defs. Br., pp. 10-11, citing a string of federal cases. However, even where phrased as "confidential" business information, such information is only sealed when a showing is made by Defendants that that information is actually confidential, and its release would be harmful. None of the cases Defendants cite involve the sealing of documents that contain superseded, outdated policies and procedures, or discussions of policies, procedures or strategies that are publicly known. *See, e.g.*, *Prochaska & Assoc. v. Merrill Lynch Pierce Fenner & Smith*, 155 F.R.D. 189, 191 (D.Neb. 1993) (finding <u>current</u> compliance policies of Defendant confidential where Defendant submitted three

a declaration to be conclusory or unpersuasive, it can find that Defendants failed to demonstrate any overriding interest that overcomes the right of public access and unseal the record. *Id.* California courts could not be more emphatic about the moving party's burden to establish specific facts demonstrating an overriding interest justifying sealing for each record: "[W]ithout a clear enumeration of *specific facts* alleged to be worthy of the extraordinary measure of maintaining our records under seal, there is simply no basis to conclude that unsealing the records will actually infringe any interest of [moving party] or inflict any harm on it." *H.B. Fuller Co. v. Doe*, 151 Cal. App. 4th 879, 898 (2007) (emphasis in original) (brackets added).

Here, Defendants merely submit declarations that parrot Section 3426.1 of the Civil Code (defining trade secrets), and conclude that outdated, superseded policies, six to seven year old emails, and information regarding Hazan and Arenstein rise to the level of trade secrets or information subject to constitutional privacy protection. Defendants' trade secrets claims are conclusory, vague and not tied to specific information in a specific document.[17] A trade secret is defined as information that (1) derives independent economic value, actual or potential, from not being generally known to the public or to other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. Civ. Code § 3426.1(d). Defendants do not specify, for each document they seek to seal, the information that purportedly possesses economic value and what that economic

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affidavits with specific allegations of potential damage to business if the information in the documents were revealed); *Bank of New York v. Meridien Biao Bank Tanzania, Ltd.*, 171 F.R.D. 135, 144 (S.D.N.Y. 1997) (finding that bank's current Credit Policy Manual, Authorized Signature Book, Audit Review Manual, Internal Auditing Manual and Operations Manual would be sealed because the Bank made showing that the manuals were only selectively provided to internal employees, that the Bank had spent significant time and money in developing the manuals and ensuring their secrecy, and that knowledge of these policies and procedures would diminish the bank's competitive edge and confer on its competitors an unwarranted advantage in the industry.); *Gohler v. Wood*, 162 F.R.D. 691 (D.Utah 1995) (finding accounting firm's current audit practice manuals would be sealed as Defendant had made showing that they had made substantial investments of time and money in creating the manuals, which contained distinctive accounting and auditing procedures, that they had went to great lengths to guard the confidentiality of the manuals as used internally, and that disclosing the complete audit manuals would be detrimental to its business because competitors could copy their methods.). Defendants have made no such showing here as to any of the materials they seek to seal.

[17] Mr. Melz only specifically references four documents out of the hundreds Merrill seeks to seal as containing confidential business information. Melz Dec., ¶¶ 13, 14. Dunphy fails to specifically reference a single document Goldman Defendants seek to seal.

value is.

General business know-how, knowledge and skill is not a trade a secret. *Providian*, 96 Cal. App. 4th at 308-09. The trade secret must provide a non-trivial advantage over others beyond just being generally helpful or useful. *Yield Dynamics, Inc. v. Tea Systems Corp.*, 154 Cal. App. 4th 547, 564-65 (2007). Virtually none of the material in question was marked confidential prior to this litigation, which is evidence that Defendants did not consider the material to be trade secrets. *See Gemisys Corp. v. Phoenix American, Inc.*, 186 F.R.D. 551, 560 (N.D. Cal. 1999) ("Regardless of whether [party claiming trade secrets] was required by the agreement to mark the program or materials as confidential, its failure to mark any of the materials it provided to [opposing party], including the PMIS software, indicates that [party claiming trade secrets] did not regard those materials as confidential, much less trade secret."). Most of the documents are just ordinary emails sent in the course of an employee's work day. *See, e.g.*, Ex. 18 to Sommer Decl.

The vast majority of the information at issue in this motion is from the 2005-2006 time period, *i.e.*, it is around six to seven years old. Some of the information is even older, dating back to 2004. By way of comparison, the *Providian* court, in affirming the unsealing of the record, observed that "much of this information is up to four years old and much of it does not amount to trade secrets at all." *Providian*, 96 Cal. App. 4th at 306 n.13; *see also Taylor v. Babbitt*, 760 F. Supp. 2d 80, 88 (D.D.C. 2011) ("[O]bsolete information that provides no competitive advantage is not commercially valuable and cannot constitute a trade secret."). This case does not involve a carefully-guarded trade secret such as the formula to Coke, which can preserve its trade secret status indefinitely. The information here is, by its very nature, of value only for a limited period of time, often days, hours or minutes.

As explained in the Declaration of Michael Manzino in Support of Plaintiffs' Consolidated Opposition to Defendants' Motions to Seal, securities lending involves the use of up-to-the-minute information concerning stock lending rates, the availability of securities to borrow and lend, and the interest of clients in potentially borrowing, all of which quickly becomes stale. *See* Manzino Decl., ¶¶ 5-6, 13-14. Securities lending personnel are on the

telephone all day receiving updates from lending sources, clients and other securities lending personnel about such issues. Yet Defendants are so absurdly overreaching that they contend that testimony about Overstock being a "hot"[18] stock in 2006 is "competitively-sensitive information"! *See* Ex. A to Floren Decl., at 99 (discussing Ex. 212 to Sommer Declaration).

When Defendants' conclusory statements are examined, there is no substance to back up their assertions that such ancient material has competitive value. Declarations that generally track Section 3426.1 of the Civil Code do not establish trade secret status; rather, they merely show that the party's lawyers know how to draft declarations that track the statute. *See Providian*, 96 Cal. App. 4th at 305 (rejecting declarations that tracked Section 3426.1 as "conclusionary and lacking in helpful specifics" as to the specific documents in question).

It is important to observe that Defendants put the most emphasis on sealing documents reflecting the very policies that they claimed at oral argument were common knowledge: "[I]t was common knowledge in the marketplace that Merrill Pro and GSEC were not borrowing shares for market-maker trades because we were doing it for all of our market-maker customers. It wasn't just for Hazen [sic]." Jan. 5, 2012 Tr., at 23:21-24. Documents containing material that has been disclosed to the public cannot contain trade secrets and may not be sealed on that basis. *Providian*, 96 Cal. App. 4th at 304. Thus, Defendants have waived any possible claim of trade secrets concerning their intentionally failing trades, including but not limited to conversion trades. In truth, Defendants do not seek to preserve a trade secret; rather, they seek to avoid disclosure of documents that are evidence of what they did. *See* Manzino Decl., ¶¶ 18-19 (purchase of conversions by securities lending personnel was not a secret, and improper and unlawful strategies involving such conversions have become public via sanctions orders). Defendants cannot argue at the summary judgment hearing that those policies were common knowledge and then try to withhold incriminating emails exposing the policies on the ground that the emails contain valuable trade secrets unknown to competitors. The hypocrisy is staggering.

Defendants' concern here is not protecting any trade secrets. Rather, Defendants

[18] A "hot" stock refers to a stock that clients were interested in shorting and, consequently, borrowing from a clearing firm's securities lending department. *See* Manzino Decl., ¶ 5.

want to conceal from the public the nature and extent of their relationships with Hazan, Arenstein and others because it may (should) embarrass them and put them in a bad light, not because these facts will reveal any trade secret. The SEC banned Hazan from trading for a minimum of five years and fined him millions of dollars, so there is no competitive advantage that could be impaired by not sealing his communications with Defendants. Cirangle Dec., Ex. C; Manzino Decl., ¶ 15. Arenstein was banned from trading for five years by the NASD and also fined millions of dollars. Cirangle Dec., Ex. C. Again, there is no competitive advantage at issue. Manzino Decl., ¶ 15. Indeed, neither Hazan nor Arenstein has been a client of the Merrill or Goldman Defendants since 2007. Likewise, Keystone was also sanctioned and is no longer a client of the Merrill or Goldman Defendants. Cirangle Dec., Ex. I. [19]

Defendants' primary concern is to shield information that may expose wrongdoing on their part and/or embarrass them, but such concerns do not establish an interest that overrides the strong presumption of public access. *See Huffy Corp. v. Superior Ct.*, 112 Cal. App. 4th 97, 108 (2003) (no overriding interest warrants "secreting from the public documents filed in its courts" showing that there may have been violations of federal and state pollution laws); *Foltz v. State Farm Mut. Auto. Ins. Co.*, 331 F.3d 1122, 1136 (9th Cir. 2003) (a litigant is not entitled to

[19] Defendants also claim they have a duty to protect client confidential information and argue that as a secondary basis for sealing some subset of the documents. Melz specifically references five documents that fall into this category (Melz Dec., ¶16); Ms. Dunphy fails to specifically reference any. This argument also fails for many reasons. First, most of the documents are emails with clients, not financial records such as those the court discussed in Defendants' case, *Valley Bank of Nevada v. Sup. Ct.*, 15 Cal. 3d 652 (1975), which concerns whether documents should be produced in the first instance, not a sealing motion. Second, to the extent the records contain any client confidential information, the majority of them concern Hazan and Arenstein's accounts. Given their public sanctioning for the same trading in these same accounts, Hazan and Arenstein have no continuing privacy interest in trading account information. The same is also true of the trading by the other Merrill and Goldman customers that formed the basis of their sanctions. Third, to the extent any remaining customer information exists in the documents Defendants seek to seal, any privacy concerns could easily be addressed through simple redaction of any such information. For example, Defendants' "blue sheets" for the trading in OSTK could be unsealed as to the manipulative trading at issue in the case, and the rest kept private. This could easily be accomplished by unsealing the exhibits to Marc Allaire's declaration, which contain the manipulative trades he culled from the blue sheets, while keeping the rest of the blue sheets under seal. Another example would be, if an email string discussed Hazan and Arenstein's trades but makes mention of unrelated client confidential information, that portion of the email could be redacted. There are simple solutions to any potentially legitimate issues of client confidentiality, but Defendants have chosen to utterly ignore them. Because Defendants have not met their burden to establish that any sealing order is narrowly tailored, the records must be unsealed.

the court's protection merely because it may be "embarrassed, incriminated or exposed to litigation through dissemination of materials"). Nor is a non-party entitled to protection because it may be exposed to litigation. *See Huffy*, 112 Cal. App. 4th at 109 (rejecting defendant's argument that "the identities of other parties which have been identified by a government agency of violating federal and state and environmental laws must be sealed" because there was no overriding interest).

Defendants should be embarrassed and want to hide details of setting up their systems to intentionally fail to deliver stocks, given that their central role in the integrity of the United States stock market is to ensure delivery of stock. Goldman Defendants should be embarrassed and want to hide details of their knowing purchases of non-existent stock from traders they knew were abusing their options market maker exemptions to meet their stock lending demands and perpetuate short selling in vulnerable stocks, thereby destroying companies in order to earn Goldman more profits. These facts are shameful. However, the fact that Defendants' actions are embarrassing and not the type of information they want known to the public does not qualify them for the narrow, limited sealing of public records available under California law.

2. For each document, Defendants have not shown that a substantial probability exists that an overriding interest will be prejudiced if the record is not sealed.

Even where an overriding interest is found that supports sealing a specific document, such an express factual finding of an overriding interest does not end the inquiry. Even where an overriding interest exists for a specific record, there can be no sealing unless the moving party also shows a substantial probability that it will be prejudiced if the particular record is not sealed. For example, in *Huffy Corp. v. Superior Ct.*, 112 Cal. App. 4th 97 (2003), the Court of Appeal found that a defendant had established an overriding interest where the record in question was a settlement agreement that the defendant was contractually bound not to disclose. *Id.* at 107. However, the Court of Appeal found that "[n]o prejudice to defendant's legitimate business and proprietary interests will occur if the settlement agreement is ordered unsealed." *Id.*; *see also H.B. Fuller Co. v. Doe*, 151 Cal. App. 4th 879, 896 (2007) ("At no time does [moving

party] squarely address the central question, which is what harm the unsealing of these documents, or any part of them, will inflict upon its interests.").

Again, there is no evidence of any prejudice that Defendants will suffer if the information is unsealed. Indeed, Defendants' counsel argued that the Section 17200 claim should be dismissed because Defendants' business practices that led to fails-to-deliver had ceased because of regulatory enactments in 2008: "The drop [in fails-to-deliver] is a direct result of the fact that the governing federal regulations changed substantially in late 2008, and those changes made fails-to-deliver both much less common and, when they occurred, much smaller in size and much shorter in duration." Jan. 5, 2012 Tr. at 83:20-24 (argument by Goldman's counsel); *see also* Manzino Decl., ¶ 16; *accord* Cirangle Decl., Exs. L and M (Melz and Mastrianni testimony confirming Merrill's Reg SHO policies changed in 2008).

Again, prejudice must be shown on a document-by-document basis, and Defendants' charts that purport to list the overriding interests that justify sealing do not even attempt to list the purported prejudice that Defendants would suffer if a particular document were unsealed. Instead, Defendants rely exclusively on global, generic statements about vague injury they might suffer if all of the documents were unsealed. For example, the declarations of Peter Melz for the Merrill Defendants and Beverly Dunphy for the Goldman Defendants vaguely refer to potential competitive disadvantages, but fail to identify any actual, specific competitive disadvantage that would likely result from disclosure of a particular document or part of a document. Defendants provide pages and pages of filler for the Court, but the "oblique, vague, attributive, conditional, incomplete or otherwise circumlocutory manner" of the assertions renders them meaningless. *See H.B. Fuller*, 151 Cal. App. 4th at 897.

3. For each document, Defendants have not shown that the proposed sealing order is narrowly tailored and that no less restrictive means exist to protect any overriding interest.

The Merrill Defendants' proposed order fails to set forth express factual findings that establish that the order is narrowly tailored and that no less restrictive means exist to protect any overriding interest, as required by Rule 2.550(d)(4)-(5). By their failure to submit any proposed order, the Goldman Defendants have also failed to meet these two requirements.

Merrill Defendants argue that their request is "narrowly tailored" because they "went through extraordinary lengths to review the voluminous material submitted by plaintiffs and identify the specific sections of those materials [sic] should be protected....As shown by Exhibit A, Merrill Lynch's request is narrowly tailored and focuses only on the sections of the materials that should be sealed." Merrill Defendants' Motion, at 17-18. Likewise, Goldman Defendants claim their sealing request is "narrowly tailored." Goldman Defendants' Motion, at 19. These assertions are nonsense. A review of the list of materials Defendants seek to seal shows that the Defendants move to seal 95% of all discovery exhibits, in their entirety, that Plaintiffs submitted in support of their opposition to the motion for summary judgment. Defendants move to seal the entirety of the pleadings as well, except as to those portions that were previously disclosed by Plaintiffs when Plaintiffs submitted the pleadings in redacted form. In sum, Defendants made no effort to narrow their sealing request in regard to these documents.

Where a defendant overreaches in seeking sealing on an all-or-nothing basis, *Providian* instructs that the trial court should unseal the entire record. The Court in *Providian* observed that defendants claimed trade secret status for "virtually every section" of the documents at issue, while failing to propose measures such as "editing or redacting" the documents that might have reached a "reasonable accommodation" between their interests and "the strong presumption of public access."[20] *Providian*, 96 Cal. App. 4th at 309. The Court of Appeal found that the defendants were, in effect, "framing and submitting the issue on an all-or-nothing basis." *Id.* Because the defendants spurned a "line by line approach," the trial court acted properly in unsealing the entirety of all of the documents. *Id.*

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[20] In spite of what the Court of Appeal found to be an improper effort to globally seal documents, the defendants in *Providian* were actually far more reasonable than Defendants here. Unlike Defendants here who seek to seal virtually every summary judgment exhibit, the defendants in Providian conceded that a substantial percentage of the documents—28 out of 67—were not confidential. *Id.* at 296-97.

IV. CONCLUSION

For the reasons set forth above, Plaintiffs respectfully request the Court deny Defendants' Motions to Seal and enter Plaintiffs' proposed order unsealing the records.

Dated: February 9, 2012

STEIN & LUBIN LLP

By: _____

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OVERSTOCK.COM, INC., KEITH CARPENTER, OLIVIER CHENG, FERN BAILEY and WENDY MATHER, as Co-Personal Representatives of the Estate of MARY HELBURN, ELIZABETH FOSTER, HUGH D. BARRON, DAVID TRENT, and MARK MONTAG

Exhibit 8

Goldman Sachs settles short-sales allegations

By Marcy Gordon, Associated Press

WASHINGTON — Goldman Sachs(GS) has agreed to pay $450,000 to settle regulators' allegations that it violated a rule related to short-selling of stocks in 2008-2009, it was announced Tuesday.

The banking company did not admit or deny wrongdoing in paying the civil penalties in agreements with the Securities and Exchange Commission and the New York Stock Exchange's regulatory arm.

The case involving Goldman's stock-trading business is unrelated to the SEC's civil fraud charges filed against the firm last month over mortgage securities transactions it arranged. Goldman has denied the allegations in that case and said it will contest the charges in court.

The rule in the short-selling case involves naked short-selling and was installed by the SEC at the height of the market distress in the fall of 2008.

Short sellers often borrow a company's shares in a short sale, hoping to make a profit when the shares decline. Naked short-selling occurs when sellers don't own or borrow the shares before selling them.

The SEC also censured the brokerage subsidiary based in Jersey City, N.J., Goldman Sachs Execution & Clearing LP, in its administrative proceeding in the case. Censure generally brings the possibility that the firm could face a stiffer sanction if the alleged infraction is repeated.

While Goldman neither admitted nor denied the allegations, it did agree to refrain from future violations of the short-selling rule.

The SEC put in the rule as a temporary emergency measure at the height of market turmoil in October 2008 as the financial crisis struck with full force. The rule expired in July 2009 but the agency made it permanent that month.

Under the rule, brokers acting for short sellers must find a party believed to be able to deliver the shares within three days after the short-sale trade. If the shares aren't delivered within that time, there is deemed to be a "failure to deliver." Brokers can be subject to penalties if the failure to deliver isn't resolved by the start of trading on the following day.

In its order, the SEC said Goldman Sachs Execution & Clearing violated the rule "by failing to deliver certain securities or immediately purchase or borrow securities, to close out the fail-to-deliver position ... on the required date."

The agency said it took into account, in accepting Goldman's settlement offer, the firm's prompt actions to remedy the problem and its cooperation with the SEC staff.

NYSE Regulation said a hearing officer had found that from early December 2008 to mid-January 2009, Goldman Sachs Execution & Clearing failed on "approximately" 68 occasions to close out in time fail-to-deliver positions in stocks. The firm also "failed to reasonably supervise and implement adequate controls" to ensure compliance with the short-selling rule, NYSE Regulation said.

Some financial industry officials have maintained that the SEC's rule brought unintended negative consequences, such as wilder price swings and turbulence in the market.

In recent months, the agency has been considering several new approaches to reining in rushes of regular short-selling, which can cause dramatic plunges in stock prices.

Investors and lawmakers have been clamoring for the SEC to put new curbs on trading moves they say worsened the market's downturn starting in the fall of 2008.

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Exhibit 7

U.S. Securities and Exchange Commission

SEC and NYSE Settle Enforcement Actions Against Goldman Sachs Unit for Role in Customers' Illegal Trading Scheme

FOR IMMEDIATE RELEASE
2007-41

Washington, D.C., March 14, 2007 - The Securities and Exchange Commission and the NYSE Regulation, Inc. today settled separate enforcement proceedings against a prime broker and clearing affiliate of The Goldman Sachs Group, Inc. for its violations arising from an illegal trading scheme carried out by customers through their accounts at the firm. Both proceedings find that firm customers traded and profited by illegally selling securities short just prior to public offerings of the companies' securities. In connection with the illegal short sales, the SEC and the NYSE found that the affiliate, Goldman Sachs Execution and Clearing L.P. (Goldman), violated the regulations requiring brokers to accurately mark sales long or short and restricting stock loans on long sales. The SEC and the NYSE further found that, if Goldman had instituted and maintained appropriate procedures, it could have discovered through its own records the customers' illegal activity.

The SEC Order and the NYSE's Decision allege that Goldman's customers carried out the illegal short-selling scheme by placing their orders to sell through the firm's REDI System© - Goldman's direct market access, automated trading system - and falsely marking the orders "long." Relying solely on the way its customers marked their orders, Goldman executed the transactions as long sales. In addition, because the customers had sold the securities short and did not have the securities at settlement date, Goldman delivered borrowed and proprietary securities to the brokers for the purchasers to settle the customers' purported "long" sales. Both the SEC Order and the NYSE Decision find that, as described in the Order and Decision, Goldman's exclusive reliance on its customers' representations that they owned the offered securities was unreasonable.

Linda Chatman Thomsen, Director of the SEC's Division of Enforcement, said, "Customers now have direct market access platforms such as REDI© and other automated trading systems, which enable brokers to execute larger volumes of trades more quickly and efficiently for their customers. However, as this case makes clear, direct access does not obviate a broker's own responsibilities under the Commission's short sale rules, and it certainly does not allow a broker to ignore apparent discrepancies indicating illegal trading by its customers."

David Nelson, Regional Director of the SEC's Southeast Regional Office in Miami said, "A broker must have a reasonable basis to believe its customers' representations that they own the securities they are selling. If, as in this case, there are significant trading disparities indicating that a customer may be lying to the broker, the broker must investigate the customer's trading and review its trading records to determine whether it can reasonably

continue to rely on the customer's representations."

Susan Merrill, Executive Vice President of Enforcement, NYSE Regulation, said, "Blind reliance on customer representations that the customer is long the securities being sold is inappropriate when a firm is confronted with a customer's repeated failures to deliver and other evidence of improper short selling."

The SEC's Order and the NYSE Decision against Goldman find that for more than two years, beginning in March 2000, the customers' pattern of trading and Goldman's own records reflected that they were selling the securities short in violation of Rule 105 and Rule 10a-1(a). The customers did not deliver to Goldman in time for settlement the securities they purported to sell long, but rather, had to borrow the securities from Goldman to settle all of their sales. Goldman's records also reflected that its customers covered their short positions with securities purchased in follow-on and secondary offerings after executing their sales. Had Goldman instituted and maintained procedures reasonably designed to detect these significant trading disparities, it could have discovered the pattern of unlawful trades by its customers.

The SEC Order and NYSE Decision find that as a result of its failure to investigate the disparity between its customer's trading and the "long" designations on their sales orders, Goldman violated the Commission's short sale rules directly by allowing its customers to mark their orders "long" and lending them borrowed and proprietary securities to settle their sales. The order and decision also find that Goldman was a cause of its customers' violations of the short sale rules. The NYSE Decision further finds that Goldman failed to reasonably supervise its business activities.

The SEC Order and the NYSE Decision censure Goldman for its conduct and compel the firm to pay $2 million in civil penalties and fines. The SEC Order also directs Goldman to cease and desist from committing or causing any violations or future violations of Section 10(a) of the Securities Exchange Act of 1934 and Rule 10a-1(a), thereunder, and Rules 200(g) and 203(a) of Regulation SHO. (Rules 200(g) and 203(a) of Regulation SHO replaced Rule 10a-1(d) and Rule 10a-2, respectively, in January 2005.) Goldman consented to the order and decision without admitting or denying the findings made by the SEC or the NYSE. In determining to accept Goldman's offers of settlement, the SEC the NYSE considered remedial measures taken by Goldman.

The SEC previously brought a settled civil injunctive action against two of Goldman's customers who had engaged in the illegal short sales and who, pursuant to the settlement, paid over $1 million in disgorgement and civil penalties.

# # #

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- Additional materials: Administrative Proceeding; Release No. 34-55465

http://www.sec.gov/news/press/2007/2007-41.htm

Exhibit 6

THE WALL STREET JOURNAL.
WSJ.com

October 7, 2008, 4:05 PM ET

Dick Fuld's Vendetta Against Short-Sellers—and Goldman Sachs

By Heidi N. Moore

Was Lehman Brothers Holdings CEO Dick Fuld driven to distraction by short-sellers as the company's stock price plunged this year?

Well consider Fuld's congressional testimony Monday and internal Lehman documents released by lawmakers, which paint a picture of an executive so intent on bringing down short-sellers that, in the words of one skeptical Congressman, Fuld's judgment may have been "clouded" as to the financial standing of his securities firm.

Reuters

Fuld didn't let up on his hatred for short-sellers–primarily David Einhorn–even after his company filed for bankruptcy last month, and he believed the shorts were part of a cabal driven by Goldman Sachs Group.

In April, Fuld reported back to general counsel Thomas Russo about a dinner with Treasury Secretary Hank Paulson that Lehman had a "huge brand with treasury," which "loved our capital raise" and, in perhaps an oblique reference to short-sellers, that Treasury "want to kill the bad HFnds + heavily regulate the rest."

Still, it seems Lehman was as worried about short-sellers as about a need for more capital. And as The Wall Street Journal reported today, when Lehman was in talks to take $5 billion of capital from Korea Development Bank in the spring, executive David Goldfarb suggested Lehman should spend about half the money to buy back Lehman stock, "hurting Einhorn bad!!!" "I agree with all of it," Mr. Fuld responded.

Fuld's obsession with the shorts prompted him to demote executives dealing with short-sellers such as finance chief Erin Callan, who had jousted with Einhorn for several months. Later, Callan told Fortune magazine she hadn't wanted to confront Einhorn, but that the rest of the management team–including Fuld–forced her to.

In July, a former Lehman executive named Jarret Wait stopped by Lehman's offices and said, according to an email by Lehman executive Thomas Humphrey, "that in just a few weeks on the 'buy' side,...it is very clear that GS is driving the bus with the hedge fund kabal& greatly influencing downside momentum,Leh &

others!" Fuld responded to the executive who forwarded him the email, "Should we be too surprised. Remember this though–I will."

In his prepared Congressional testimony, Fuld wrote, "The naked shorts and rumor mongers succeeded in bringing down Bear Stearns. And I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers." When Fuld was questioned about the shorts' connection to Goldman, he grumbled that he had no evidence but didn't sound convinced.

It isn't clear, though, how Fuld rationalized that with the appearance that the shorts were attacking Goldman, too. In his prepared Congressional testimony, Fuld said, "On September 15, when the market opened after the collapse of Lehman, naked shorts appeared to turn their attention to Morgan Stanley and Goldman Sachs. In the three days between the announcement of Lehman Brothers' bankruptcy and the SEC instituting an emergency ban on short selling, Goldman Sachs' and Morgan Stanley's share prices fell 30% and 39% respectively. None of this was a coincidence."

Exhibit 5

U.S. Securities and Exchange Commission

SEC Enhances Investor Protections Against Naked Short Selling

FOR IMMEDIATE RELEASE
2008-143

Washington, D.C., July 15, 2008 - The Securities and Exchange Commission today issued an emergency order to enhance investor protections against "naked" short selling in the securities of Fannie Mae, Freddie Mac, and primary dealers at commercial and investment banks.

Additional Materials

- Amendment to Emergency Order
- Submit Comments on Emergency Orders (File No. S7-20-08)
- Emergency Orders FAQs

The SEC's order will require that anyone effecting a short sale in these securities arrange beforehand to borrow the securities and deliver them at settlement. The order will take effect at 12:01 a.m. ET on Monday, July 21. In addition to this emergency order, the SEC will undertake a rulemaking to address these issues across the entire market.

"The SEC's mission to protect investors, maintain orderly markets, and promote capital formation is more important now than it has ever been," said SEC Chairman Christopher Cox. "Today's Commission action aims to stop unlawful manipulation through 'naked' short selling that threatens the stability of financial institutions. We will continue our vigorous commitment to investors by working within the SEC and in close cooperation with our regulatory counterparts to promote the continued health and vibrancy of our markets."

The Commission's emergency order, pursuant to its authority under Section 12(k)(2) of the Securities Exchange Act of 1934, will be effective at 12:01 a.m. ET on July 21, 2008 and will terminate at 11:59 p.m. ET on July 29, 2008. The Commission may extend the order to continue it in effect thereafter if the Commission determines that the continuation of the order is necessary in the public interest and for the protection of investors, but for no more than 30 calendar days in total duration.

# # #

The securities identified in the Commission's order:

Company	Ticker Symbol(s)
BNP Paribas Securities Corp.	BNPQF or BNPQY
Bank of America Corporation	BAC
Barclays PLC	BCS
Citigroup Inc.	C

Credit Suisse Group	CS
Daiwa Securities Group Inc.	DSECY
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J. P. Morgan Chase & Co.	JPM
Lehman Brothers Holdings Inc.	LEH
Merrill Lynch & Co., Inc.	MER
Mizuho Financial Group, Inc.	MFG
Morgan Stanley	MS
UBS AG	UBS
Freddie Mac	FRE
Fannie Mae	FNM

http://www.sec.gov/news/press/2008/2008-143.htm

Exhibit 4

Rolling Stone

Wall Street's Naked Swindle

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

by: Matt Taibbi

Illustration by Victor Juhasz

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.

This article appeared in the October 15, 2009 issue of Rolling Stone. The issue is available in the online archive.

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...

Why Isn't Wall Street in Jail?

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.

Looting Main Street

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.

Taibblog: Matt Taibbi on Politics and the Economy

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 the 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 spokesperson 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 SusanneTrimbath, 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 incorporations, 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 100shares 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 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 thee 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.

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"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 sub-prime 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 $29billion 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 byte 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 sub-prime 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.
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Exhibit 3

Bloomberg

Naked Short Sales Hint Fraud in Bringing Down Lehman (Update1)

March 19 (Bloomberg) -- The biggest bankruptcy in history might have been avoided if Wall Street had been prevented from practicing one of its darkest arts.

As Lehman Brothers Holdings Inc. struggled to survive last year, as many as 32.8 million shares in the company were sold and not delivered to buyers on time as of Sept. 11, according to data compiled by the Securities and Exchange Commission and Bloomberg. That was a more than 57-fold increase over the prior year's peak of 567,518 failed trades on July 30.

The SEC has linked such so-called fails-to-deliver to naked short selling, a strategy that can be used to manipulate markets. A fail-to-deliver is a trade that doesn't settle within three days.

"We had another word for this in Brooklyn," said Harvey Pitt, a former SEC chairman. "The word was 'fraud.'"

While the commission's Enforcement Complaint Center received about 5,000 complaints about naked short-selling from January 2007 to June 2008, none led to enforcement actions, according to a report filed yesterday by David Kotz, the agency's inspector general.

The way the SEC processes complaints hinders its ability to respond, the report said.

Twice last year, hundreds of thousands of failed trades coincided with widespread rumors about Lehman Brothers. Speculation that the company was being acquired at a discount and later that it was losing two trading partners both proved untrue.

After the 158-year-old investment bank collapsed in bankruptcy on Sept. 15, listing $613 billion in debt, former Chief Executive Officer Richard Fuld told a congressional panel on Oct. 6 that naked short sellers had midwifed his firm's demise.

Gasoline on Fire

Members of the House Committee on Government Oversight and Reform weren't buying that

explanation.

"If you haven't discovered your role, you're the villain today," U.S. Representative John Mica, a Florida Republican, told Fuld.

Yet the trading pattern that emerges from 2008 SEC data shows naked shorts contributed to the fall of both Lehman Brothers and Bear Stearns Cos., which was acquired by JPMorgan Chase & Co. in May.

"Abusive short selling amounts to gasoline on the fire for distressed stocks and distressed markets," said U.S. Senator Ted Kaufman, a Delaware Democrat and one of the sponsors of a bill that would make the SEC restore the uptick rule. The regulation required traders to wait for a price increase in the stock they wanted to bet against; it prevented so-called bear raids, in which successive short sales forced prices down.

Driving Down Prices

Reinstating the rule would end the pattern of fails-to- deliver revealed in the SEC data, Kaufman said.

"These stories are deeply disturbing and make a compelling case that the SEC must act now to end abusive short selling -- which is exactly what our bill, if enacted, would do," the senator said in an e-mailed statement.

Short sellers arrange to borrow shares, then dispose of them in anticipation that they will fall. They later buy shares to replace those they borrowed, profiting if the price has dropped. Naked short sellers don't borrow before trading -- a practice that becomes evident once the stock isn't delivered. Such trades can generate unlimited sell orders, overwhelming buyers and driving down prices, said Susanne Trimbath, a trade- settlement expert and president of STP Advisory Services, an Omaha, Nebraska-based consulting firm.

The SEC last year started a probe into what it called "possible market manipulation" and banned short sales in financial stocks as the number of fails-to-deliver climbed.

'Unsubstantiated Rumors'

The daily average value of fails-to-deliver surged to $7.4 billion in 2007 from $838.5 million in 1995, according to a study by Trimbath, who examined data from the annual reports of the National Securities Clearing Corp., a subsidiary of the Depository Trust & Clearing Corp.

Trade failures rose for Bear Stearns as well last year. They peaked at 1.2 million shares on March 17, the day after JPMorgan announced it would buy the investment bank for $2 a share. That was more

than triple the prior-year peak of 364,171 on Sept. 25.

Fuld said naked short selling -- coupled with "unsubstantiated rumors" -- played a role in the demise of both his bank and Bear Stearns.

"The naked shorts and rumor mongers succeeded in bringing down Bear Stearns," Fuld said in prepared testimony to Congress in October. "And I believe that unsubstantiated rumors in the marketplace caused significant harm to Lehman Brothers."

Devaluing Stock

Failed trades correlate with drops in share value -- enough to account for 30 to 70 percent of the declines in Bear Stearns, Lehman and other stocks last year, Trimbath said.

While the correlation doesn't prove that naked shorting caused the lower prices, it's "a good first indicator of a statistical relationship between two variables," she said.

Failing to deliver is like "issuing new stock in a company without its permission," Trimbath said. "You increase the number of shares circulating in the market, and that devalues a stock. The same thing happens to a currency when a government prints more of it."

Trimbath attributes the almost ninefold growth in the value of failed trades from 1995 to 2007 to a rise in naked short sales.

"You can't have millions of shares fail to deliver and say, 'Oops, my dog ate my certificates,'" she said.

Explanation Required

On its Web site, the Federal Reserve Bank of New York lists several reasons for fails-to-deliver in securities trading besides naked shorting. They include misunderstandings between traders over details of transactions; computer glitches; and chain reactions, in which one failure to settle prevents delivery in a second trade.

Failed trades in stocks that were easy to borrow, such as Lehman Brothers, constitute a "red flag," said Richard H. Baker, the president and CEO of the Washington-based Managed Funds Association, the hedge fund industry's biggest lobbying group.

"Suffice it to say that in a readily available stock that is traded frequently, there has to be an explanation to the appropriate regulator as to the circumstances surrounding the fail-to-deliver," said Baker, who served in the U.S. House of Representatives as a Republican from Louisiana from 1986 to February 2008.

"If it's a pattern and a practice, there are laws and regulations to deal with it," he said.

Fines and Penalties

Lehman Brothers had 687.5 million shares in its float, the amount available for public trading. In float size, the investment bank ranked 131 out of 6,873 public companies -- or in the top 1.9 percent, according to data compiled by Bloomberg.

While naked short sales resulting from errors aren't illegal, using them to boost profits or manipulate share prices breaks exchange and SEC rules and violators are subject to penalties. If investigators determine that traders engaged in the practice to try to influence markets, the Department of Justice can file criminal charges.

Market makers, who serve as go-betweens for buyers and sellers, are allowed to short stock without borrowing it first to maintain a constant flow of trading.

Since July 2006, the regulatory arm of the New York Stock Exchange has fined at least four exchange members for naked shorting and violating other securities regulations. J.P. Morgan Securities Inc. paid the highest penalty, $400,000, as part of an agreement in which the firm neither admitted nor denied guilt, according to NYSE Regulation Inc.

Enforcement 'Reluctant'

In July 2007, the former American Stock Exchange, now NYSE Alternext, fined members Scott and Brian Arenstein and their companies $3.6 million and $1.2 million, respectively, for naked short selling. Amex ordered them to disgorge a combined $3.2 million in trading profits and suspended both from the exchange for five years. The brothers agreed to the fines and the suspension without admitting or denying liability, according a release from the exchange.

Of about 5,000 e-mailed tips related to naked short-selling received by the SEC from January 2007 to June 2008, 123 were forwarded for further investigation, according to the report released yesterday by Kotz, the agency's internal watchdog. None led to enforcement actions, the report said.

Kotz, the commission's inspector general, said the enforcement division "is reluctant to expend additional resources to investigate" complaints. He recommended in his report yesterday that the division step up analysis of tips, designating an office or person to provide oversight of complaints.

Schapiro's Plans

"Our audit disclosed that despite the tremendous amount of attention the practice of naked short selling has generated in recent years, Enforcement has brought very few enforcement actions based

on conduct involving abusive or manipulative naked short selling," the report said.

The enforcement division, in a response included in the report, said "a large number of the complaints provide no support for the allegations" and concurred with only one of the inspector general's 11 recommendations.

SEC Chairman Mary Schapiro, who took office in January, has vowed to reinvigorate the enforcement unit after it drew fire from lawmakers and investors for failing to follow up on tips that New York money manager Bernard Madoff's business was a Ponzi scheme. She has "initiated a process that will help us more effectively identify valuable leads for potential enforcement action," John Nester, a commission spokesman, said in response to the Kotz report.

Last September, the agency instituted the temporary ban on short sales of financial stock. It also has announced an investigation into "possible market manipulation in the securities of certain financial institutions."

No Effective Action

Christopher Cox, who was SEC chairman last year; Erik Sirri, the commission's director for market regulation; and James Brigagliano, its deputy director for trading and markets, didn't respond to requests for interviews. John Heine, a spokesman, said the commission declined to comment for this story.

"It has always puzzled me that the SEC didn't take effective action to eliminate naked shorting and the fails-to- deliver associated with it," Pitt, who chaired the commission from August 2001 to February 2003, said in an e-mail. The agency began collecting data on failed trades that exceed 10,000 shares a day in 2004.

"All the SEC need do is state that at the time of the short sale, the short seller must have (and must maintain through settlement) a legally enforceable right to deliver the stock at settlement," Pitt wrote. He is now the CEO of Kalorama Partners LLC, a Washington-based consulting firm. In August, he and some partners started RegSHO.com, a Web-based service that locates stock to help sellers comply with short-selling rules.

Postponed 'Indefinitely'

Pitt began his legal career as an SEC staff attorney in 1968, and eventually became the commission's general counsel. In 1978, he joined Fried Frank Harris Shriver & Jacobson LLP, where as a senior corporate partner he represented such clients as Bear Stearns and the New York Stock Exchange. President George W. Bush appointed him SEC chairman in 2001.

The flip side of an uncompleted transaction resulting from undelivered stock is called a "fail-to-receive." SEC regulations state that brokers who haven't received stock 13 days after purchase can execute a so-called buy-in. The broker on the selling side of the transaction must buy an equivalent number of shares and deliver them on behalf of the customer who didn't.

A 1986 study done by Irving Pollack, the SEC's first director of enforcement in the 1970s, found the buy-in rules ineffective with regard to Nasdaq securities. The rules permit brokers to postpone deliveries "indefinitely," the study found.

The effect on the market can be extreme, according to Cox, who left office on Jan. 20. He warned about it in a July article posted on the commission's Web site.

Turbocharged Distortion

When coupled with the propagation of rumors about the targeted company, selling shares without borrowing "can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions," he said in the article.

"'Naked' short selling can turbocharge these 'distort-and- short' schemes," Cox wrote.

"When traders spread false rumors and then take advantage of those rumors by short selling, there's no question that it's fraud," Pollack said in an interview. "It doesn't matter whether the short sales are legal."

On at least two occasions in 2008, fails-to-deliver for Lehman Brothers shares spiked just before speculation about the bank began circulating among traders, according to SEC data that Bloomberg analyzed.

On June 30, someone started a rumor that Barclays Plc was ready to buy Lehman for 25 percent less than the day's share price. The purchase didn't materialize.

'Green Cheese'

On the previous trading day, June 27, the number of shares sold without delivery jumped to 705,103 from 30,690 on June 26, a 23-fold increase. The day of the rumor, the amount reached 814,870 -- more than four times the daily average for 2008 to that point. The stock slumped 11 percent and, by the close of trading, was down 70 percent for the calendar year.

"This rumor ranks up there with the moon is made of green cheese in terms of its validity," Richard Bove, who was then a Ladenburg Thalmann & Co. analyst, said in a July 1 report.

Bove, now vice president and equity research analyst with Rochdale Securities in Lutz, Florida, said in an interview this month that the speculation reflected "an unrealistic view of Lehman's portfolio value." The company's assets had value, he said.

'Obscene' Leverage

During the first six days following the Barclays hearsay, the level of failed trades averaged 1.4 million. Then, on July 10, came rumors that SAC Capital Advisors LLC, a Stamford, Connecticut-based hedge fund, and Pacific Investment Management Co. of Newport Beach, California, had stopped trading with Lehman Brothers.

Pimco and SAC denied the speculation. The bank's share price dropped 27 percent over July 10-11.

Banks and insurers wrote down $969.3 billion last year -- and that gave legitimate traders plenty of reason to short their stocks, said William Fleckenstein, founder and president of Seattle-based Fleckenstein Capital, a short-only hedge fund. He closed the fund in December, saying he would open a new one that would buy equities too.

"Financial stocks imploded because of the drunkenness with which executives buying questionable securities levered-up in obscene fashion," said Fleckenstein, who said his firm has always borrowed stock before selling it short. "Short sellers didn't do this. The banks were reckless and they held bad assets. That's the story."

'Market Distress'

On May 21, David Einhorn, a hedge fund manager and chairman of New York-based Greenlight Capital Inc., announced he was shorting stock in Lehman Brothers and said he had "good reason to question the bank's fair value calculations" for its mortgage securities and other rarely traded assets.

Einhorn declined to comment for this story. Monica Everett, a spokeswoman who works for the Abernathy Macgregor Group, said Greenlight properly borrows shares before shorting them.

Even when they're legitimate, short sales can depress share values in times of market crisis -- in effect turning the traders' negative bets into self-fulfilling prophecies, says Pollack, the former SEC enforcement chief who is now a securities litigator with Fulbright & Jaworski in Washington.

The SEC has been concerned about the issue since at least 1963, when Pollack and others at the commission wrote a study for Congress that recommended the "temporary banning of short selling, in all stocks or in a particular stock" during "times of general market distress."

Airport Runway

On Sept. 17, two days after Lehman Brothers filed for Chapter 11 bankruptcy, the number of failed trades climbed to 49.7 million, 23 percent of overall volume in the stock.

The next day, the SEC announced its ban on shorting financial companies in 2008. The number of protected stocks ultimately grew to about 1,000. On Sept. 19, the commission announced "a sweeping expansion" of its investigation into possible market manipulation.

The ban, which lasted through Oct. 17, didn't eliminate shorting, according to data from the SEC, the NYSE Arca exchange and Bloomberg. Throughout the period, short sales averaged 24.7 percent of the overall trading in Morgan Stanley, Merrill Lynch & Co. and Goldman Sachs Group Inc. on NYSE Arca. In 2008, short sales averaged 37.5 percent of the overall trading on the exchange in the three companies.

To date, the commission hasn't announced any findings of its investigation.

Pollack, the former SEC regulator, wonders why.

"This isn't a trail of breadcrumbs; this audit trail is lit up like an airport runway," he said. "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."

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Exhibit 2

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Edgar Sargent

Counsel to WMI Liquidating Trust,
Litigation Subcommittee

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
WASHINGTON MUTUAL, INC., et al.,	Case No. 08-12229 (MFW)
	Jointly Administered
Debtors	

DECLARATION OF DR. ROBERT SHAPIRO IN SUPPORT OF WASHINGTON MUTUAL INC. LIQUIDATING TRUST'S MOTION FOR AN ORDER AUTHORIZING AN EXAMINATION OF GOLDMAN SACHS PURSUANT TO BANKRUPTCY RULE 2004

Dr. Robert Shapiro declares:

1. I am the chairman of the economics research and advisory firm Sonecon, LLC. A copy of my curriculum vitae is attached as Exhibit A. As it indicates, I have a doctorate in political economy from Harvard University.

2. I was retained by the Litigation Subcommittee of the Washington Mutual Inc. Liquidating Trust (WMILT) in July 2012. I was asked to conduct a preliminary analysis of Washington Mutual Inc.'s common stock share price from mid-2007 through the bankruptcy filing on September 26, 2008.

3. I and others from Sonecon working under my direction examined the impact of several factors on WMI's share price, including: (1) changes in the price movements of the overall market and comparable financial institutions; (2) publicly released news about WMI; and (3) the level of short sale transactions and apparent "naked short" transactions of WMI shares. This was a preliminary analysis, based solely on publicly available information, and the results could require modification or change with additional information and knowledge of this case.

4. Within these parameters, my conclusions at the current stage of analysis are that (1) the first two factors identified in the previous paragraph do not explain the entire decline in value of WMI's shares; and (2) the additional decline in the share price of WMI may be explained by the abnormally high level of short trading of WMI's stock and a large volume of "fails to deliver" (FTD) of the stock.

5. In order to identify the impact on WMI of the movements in the overall market, we compared the history of WMI's share price to the share prices of Countrywide and Lehman Brothers, two financial institutions that were, like WMI, heavily invested in subprime mortgages and which failed in late-2008. We also analyzed the price changes of the S&P 500 index. A chart showing these share and index price histories is Exhibit B to this Declaration.

6. This analysis suggests that the pattern of decline in the share price of WAMU cannot be explained by movements in the overall market (S&P 500), or by a pattern common to institutions heavily invested in subprime mortgages which also failed (Countrywide and Lehman).

7. We also analyzed the impact of public news about Washington Mutual on the WMI share price by performing a preliminary "event study." We created a market model using a least-squares regression methodology, a form of analysis that is widely accepted in economics

and finance. We calculated the relationship between daily price returns on WMI shares and daily price returns on the S&P 500 by first examining the eighteen-month period leading up to July 1, 2007, the date when our relevant timeframe begins. The relevant time period could change when additional facts and evidence are available and analyzed.. We determined that WMI's daily price returns and the S&P 500 daily price returns moved together very closely during those eighteen months. In technical terms, the beta coefficient generated by the regression analysis was 0.996570 with a t-statistic of 14.06, suggesting that the movements of WMI shares and the S&P 500 were very closely correlated and that this result is highly statistically significant. We then applied the statistical results of this analysis to the relevant period of our study, July 1, 2007 through September 25, 2008 and used it to conduct a preliminary analysis of the impact on WMI's share price of available news and public information about the company. We began by searching for WMI company news in Factiva Dow Jones database for news and events related to Washington Mutual. Our preliminary search identified relevant news and events on 32 trading days during the relevant period. We then calculated the expected daily price return on WMI shares for non-news days by multiplying the beta coefficient (i.e., 0.996570) to the S&P 500 daily price return for those days. For news days, we calculated a "but for" WMI share price. For news days on which WMI's daily price returns rose, we used the higher daily price return of WMI or the daily price return of the S&P 500 to calculate "but for" WMI share prices. For news days on which WMI's daily price returns declined, we used the lower of the daily returns of WMI or the daily price returns of the S&P 500 to calculate the "but for" WMI share prices. This framework allows us to capture both the largest negative and positive effects of news on WMI's share prices.

8. The results of this analysis are represented on the chart attached as Exhibit C. The top line of this chart (in red) shows what WMI's share price would have been if the prior relationship to the S&P 500 had been sustained throughout the relevant period. The green line depicts what WMI's share price would have been based on the prior relationship for the S&P 500 but corrected to account for the news events. The blue line shows WMI's actual share price during the period. This analysis shows that events significantly reduced WMI's share price relative to its established relationship to the S&P 500. It also shows that a significant portion of WMI's share price decline cannot be explained by the news events. Like all event studies, these findings depend on the number and nature of the related news and the starting date of the relevant period. Additional information and evidence may affect our preliminary findings and opinions.

9. To summarize our current results, WMI's share price declined 94.8 percent from July 1, 2007 to September 24, 2008. During the same period, the S&P 500 index declined 22.0 percent. If WMI's share price movements had maintained the same relationship to the movements in the S&P 500 during the preceding period, it would have declined 21.9 percent in the relevant period. After adjusting for news developments on 32 trading days, we estimate that WMI's share price should have declined 70.7 percent. Thus, we conclude that other factors must explain the remaining decline of 24.1 percent in those share prices.

10. We also examined short sales and failures to deliver (FTD) of WMI shares during the relevant period. To do so, first we obtained data on the short interest and outstanding shares of some 4,500 of the 6,700 companies traded on major U.S. security exchanges. These data show that WMI's short interest increased from an average of about 3 percent of its outstanding shares, based on end-of-quarter data for seven quarters from December 2005 to June 2007, to

14.5 percent of its outstanding shares in five end-of-quarters from September 2007 to September 2008. These levels of short interest as a percentage of outstanding shares from September 2007 to September 2008 are highly abnormal.

11. Next, we compared WMI's short interest with the short interest of Countrywide and Lehman Brothers, two other financial companies that also collapsed in the third quarter of 2008. Countrywide was taken over by Bank of American on July 1, 2008, and Lehman Brothers filed for bankruptcy on September 15, 2008. In all of these instances, short interest as a share of the companies' outstanding shares rose sharply.

12. However, in the months preceding the collapse of these companies, WMI's short interest claimed a larger portion of its outstanding shares than was the case for Lehman Brothers or Countrywide.

13. Next we examined data indicative of naked short selling of WMI shares. A naked short sale is one in which the short-seller sells shares but does not obtain and deliver any shares (by borrowing or otherwise) by T+3 (three days after the sale). . Under SEC regulations, a seller (both long and short sales) must deliver shares within three days of closing a transaction. If this delivery does not occur, the transaction is reported as a "failure to deliver" or FTD. FTDs can be caused by a number of factors in both long and short sales; and without additional evidence, we cannot be certain that every FTD in this case results from a naked short. However, naked shorting is by far the most common cause of FTDs. In some unusual instances, a FTD occurs because the delivery of paper certificates has been delayed. However, as more than 97 percent of all shares are now held in electronic form, such delays are rare. In addition, some FTDs may occur in the conduct of legitimate market maker activities. Given the nature of market maker activity, however, such FTDs should be resolved very quickly. In our experience and the views

of other experts in this area, including the SEC, large-scale sustained FTDs arise from naked short sale transactions. In our opinion, the pattern of substantially rising FTDs seen in WMI's shares almost certainly represents a large volume of naked short transactions. In fact, FTDs as a percentage of outstanding shares for all NYSE stocks have been minimal, averaging between 0.04 percent and 0.06 percent in the mid- and late-2000's. Our preliminary analysis found that FTDs of WMI accounted for more than 2.4 percent of outstanding shares and 9.7 percent of WMI short interest in the final months before the firm's collapse. In our experience and opinion, such large scale, sustained FTDs arise from large-scale naked short sale activities.

14. SEC publishes daily reports of the number of FTDs for individual stocks. We charted the monthly high FTD of WMI, which show a very high volume of FTDs in the period leading up to the company's collapse. We examined the monthly high FTD of WMI shares, as a percentage of outstanding shares, and as a percentage of WMI's short interest, for the period from December 2005 to September 2008. We determined that the FTD of WMI shares increased sharply in the four quarters prior to the company's collapse, peaking at 42 million shares at the time of the collapse in September 2008, the equivalent of 2.44 percent of outstanding shares and 9.7 percent of WMI's short interest (Exhibit D).

15. Next, we compared WMI FTD as a share of its short interest with two other failed financial companies, Countrywide and Lehman Brothers. In all cases, FTD as a share of short interest rose sharply in the months before their collapse. WMI's level of FTD as a share of short interest was generally higher than Countrywide and, until the very end, higher than Lehman Brothers (Exhibit E). .

16. The final step of our preliminary analysis was to examine the relationship between overall WMI short sales and WMI's FTD, using monthly data in all cases, for the

relevant period from July 2007 through August 2008. For this analysis we used the Granger Causality regression, which establishes the presence or absence of statistical causality between two interrelated variables.

17. This Grander Causality analysis shows that the FTD of WMI shares in one month led to higher short sales of WMI in succeeding months, *and* short sales of WMI in one month led to higher FTD of WMI shares in succeeding months. These results suggest that a cascading effect occurred between the fails and short sales of WMI stock in this period: The high fails caused additional short sales in subsequent months, and the higher short sales caused additional fails in subsequent months. These effects helped drive down the price of WMI's shares in this period (Exhibit F).

18. In conclusion, our preliminary analysis finds that the decline in the share price of WMI cannot be fully explained by either movements in the overall market or the news of specific events affecting WMI share prices. The analysis also establishes that WMI experienced abnormal levels of short sales and naked short sales or FTD in the months preceding its collapse. Finally, we also find evidence that the high levels of short sales caused higher levels of FTD, and the higher levels of FTD caused higher levels of short sales.

I affirm under penalty of perjury that the forgoing is true and correct to the best of my current knowledge and if called on to testify under oath I would do so consistently with the contents of this declaration.

DATE: November 29, 2012

Dr. Robert Shapiro

ROBERT J. SHAPIRO

PROFESSIONAL EXPERIENCE

CHAIRMAN AND CO-FOUNDER 2001-PRESENT
Sonecon, LLC *Washington, D.C.*

Chairman and co-founder of an economic advisory firm that counsels governments, corporations, legal partnerships,and non-profit entities on U.S. and global economic and financial issues. Dr. Shapiro and Sonecon have advised, among others, President Bill Clinton, British Prime Ministers Tony Blair and Gordon Brown, Vice President Albert Gore, Jr.; Senators Barack Obama and Hillary Clinton; SEC Chair Mary Shapiro; private firms such as Amgen, AT&T, Exxon-Mobil, Gilead Science, Google, NASDAQ, and Overstock, and non-profits including U.S. Chamber of Commerce, American Public Transportation Association and the Philanthropic Collaborative.

OTHER CURRENT ACTIVITIES:
ADVISORY BOARD, *INTERNATIONAL MONETARY FUND, WASHINGTON D.C.*
FELLOW, MCDONOUGH SCHOOL OF BUSINESS, *GEORGETOWN UNIVERSITY*
CHAIRMAN, *U.S. CLIMATE TASK FORCE, WASHINGTON, D.C.*
CHAIRMAN, *NDN GLOBALIZATION INITIATIVE, WASHINGTON D.C.*
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U.S. UNDER SECRETARY OF COMMERCE FOR ECONOMIC AFFAIRS 1998-2001*U.S.*
U.S. Government *Washington, D.C.*

Oversaw policy, planning and operations of the Office of Under Secretary, Census Bureau and the Bureau of Economic Analysis, managing 35 executives with responsibility for 10,000 employees and $4.5 billion (FY 2000). Oversight included Census 2000, the government's largest operational undertaking. Also, chief economic advisor for the Commerce Department, Secretary's representative to White House task forces, and directed Administration effort to assess the economic impact of information technologies and ecommerce.

CO-FOUNDER AND VICE PRESIDENT 1989-1998
Progressive Policy Institute *Washington, D.C.*

Managed major operations and strategic planning for a Washington public-policy organization and oversaw development of its economic analyses and policy positions. Extensive publications.

CO-FOUNDER AND DIRECTOR OF ECONOMIC STUDIES 1993-1997
Progressive Foundation *Washington, D.C.*

Directed economic analysis and policy development for Washington public policy foundation. Also, raised funds and developedeconomic-policy positions. Extensive publications.

CONSULTANT 1991-1997
Private practice *Washington, D.C.*

Directed and conducted analyses for and public-sector clients on antitrust, telecommunications regulation, corporate taxation, and securities issues.

ROBERT J. SHAPIRO

ASSOCIATE EDITOR 1986-1988
U.S. News & World Report *Washington, D.C.*

Senior writer on macroeconomic policy

LEGISLATIVE DIRECTOR AND ECONOMIC COUNSEL 1981-1986
Senator Daniel Patrick Moynihan *Washington, D.C.*

Managed legislative strategy and policy staff, and Senator's liaison to Senate leadership.

POLITICAL ADVISORY EXPERIENCE

ECONOMIC ADVISOR, OBAMA-BIDEN CAMPAIGN AND PRESIDENTIAL TRANSITION 2008

ECONOMIC ADVISOR, KERRY-EDWARDS CAMPAIGN 2004

SENIOR ECONOMIC ADVISOR, GORE FOR PRESIDENT AND GORE-LIEBERMAN 2001

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CLINTON FOR PRESIDENT, CLINTON-GORE AND PRESIDENTIAL TRANSITION 1991-1993

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PUBLICATIONS AVAILABLE ON REQUEST

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"The Employment Effects of Advances in Internet and Wireless Technology: Evaluating the Transitions from 2G to 3G and from 3G to 4G," with Dr. Kevin A. Hassett, New Policy Institute and NDN, January 2012.

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Exhibit B. Share prices of Washington Mutual (WMI), Lehman Brothers (LEH), Countrywide (CFC), S&P's 500 Index, July 2007 – September 2008

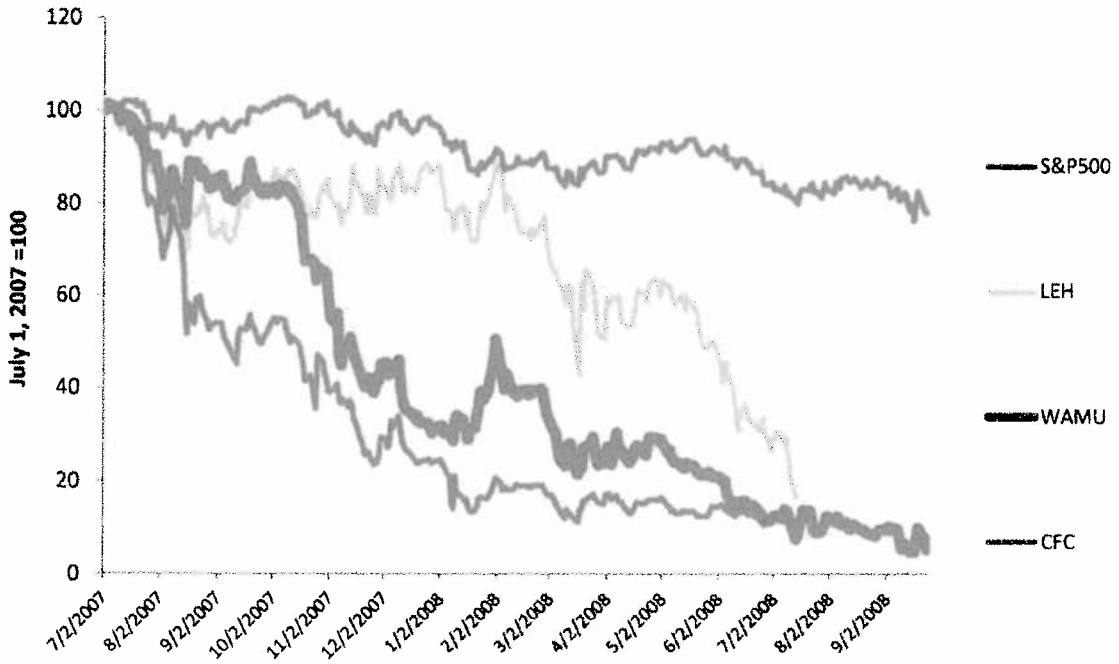

Exhibit C: WMI Share Prices Based on Its Relationship to the S&P 500, Corrected for News Events, and Its Actual Share Prices, July 1, 2007-September 24, 2008

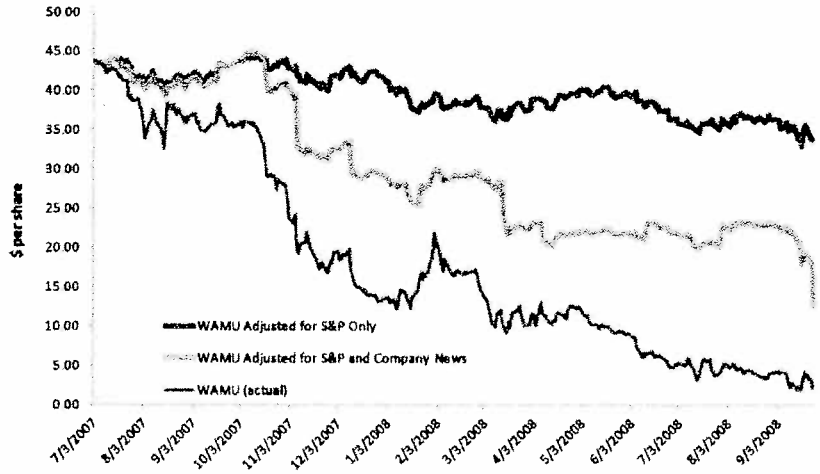

Exhibit D. Fails-to-Deliver WAMU Shares as a Share of WAMU's Outstanding Shares And as a Share of Its Short Interest, December 2005 – September 2008

	FTD	FTD as Share of Outstanding Shares	FTD as Share of Short Interest
December 2005	440,213	0.04%	1.2%
March 2006	29,362	0.00%	0.1%
June 2006	77,956	0.01%	0.4%
September 2006	2,617,541	0.28%	12.7%
December 2006	53,901	0.01%	0.2%
March 2007	524,845	0.06%	1.8%
June 2007	298,502	0.03%	0.7%
September 2007	327,467	0.04%	0.7%
December 2007	2,753,492	0.31%	3.0%
March 2008	3,853,868	0.36%	2.4%
June 2008	9,214,657	0.54%	3.2%
September 2008	41,691,761	2.44%	9.7%

Exhibit E. Fails-to-Deliver as a Share of Short Interest, December 2005-September 2008

	WAMU	Lehman Brothers	Countrywide
December 2005	1.2%	0.9%	1.3%
March 2006	0.1%	1.6%	0.4%
June 2006	0.4%	0.8%	0.4%
September 2006	12.7%	0.3%	0.5%
December 2006	0.2%	0.9%	0.7%
March 2007	1.8%	4.1%	4.2%
June 2007	0.7%	1.6%	1.8%
September 2007	0.7%	1.5%	0.6%
December 2007	3.0%	0.6%	1.5%
March 2008	2.4%	3.5%	2.8%
June 2008	3.2%	2.1%	0.6%
September 2008	9.7%	46.0%	--

Exhibit F. Granger Causality Tests

Null Hypothesis	F-statistic	Probability	Results
Short sales do not Granger cause fails-to-deliver	5.1927	0.0436	Reject the null hypothesis
Fails-to-deliver do not Granger cause short sales	3.9470	0.0724	Reject the null hypothesis

Exhibit 1

FILED UNDER SEAL

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 11
WASHINGTON MUTUAL, INC., *et al.*,[1]	Case No. 08-12229 (MFW)
Debtors.	Jointly Administered
	Objection Deadline: 12/20/2012 @ 4:00 p.m. (ET) **Hearing Date: 12/27/2012 @ 2:00 p.m. (ET)**

NOTICE OF MOTION AND HEARING

TO: Debtors; counsel for the Debtors; the Office of the United States Trustee for the District of Delaware; Goldman Sachs; counsel for Goldman Sachs; and any party requesting notice pursuant to Bankruptcy Rule 2002.

On November 30, 2012, the WMI Liquidating Trust filed the **Motion by WMI Liquidating Trust for an Order Authorizing an Examination of Goldman Sachs Pursuant to Bankruptcy Rule 2004** (the "**Motion**"), a copy of which is attached hereto.

Objections, if any, to the relief requested in the Motion must be filed with the United States Bankruptcy Court, 824 North Market Street, 3rd Floor, Wilmington, Delaware 19801, on or before **December 20, 2012 at 4:00 p.m. (ET).**

At the same time, you must also serve a copy of the objection upon the undersigned counsel so as to be **received no later than 4:00 p.m. (ET) on December 20, 2012.**

A HEARING ON THE MOTION WILL BE HELD ON **DECEMBER 27, 2012 AT 2:00 P.M. (ET)** BEFORE THE HONORABLE MARY F. WALRATH, IN THE UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF DELAWARE, 824 NORTH MARKET STREET, 5th FLOOR, COURTROOM 4, WILMINGTON, DELAWARE 19801.

[1] Debtors in these Chapter 11 cases and the last four digits of each Debtor's federal tax identification numbers are: (i) Washington Mutual, Inc. (3725) and (ii) WMI Investment Corp. (5395). The Debtors are located at 925 Fourth Avenue, Suite 2500, Seattle, Washington 98104.

IF YOU FAIL TO RESPOND IN ACCORDANCE WITH THIS NOTICE, THE COURT MAY GRANT THE RELIEF REQUESTED IN THE MOTION WITHOUT FURTHER NOTICE OR HEARING.

Dated: November 30, 2012
Wilmington, Delaware

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