SUBJECT:
Short Interest

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(Theory and Practice of Investing) A new book by a famous short-seller provides entertaining proof that all that glitters is not gold, and that Wall Street doesn't care as long as someone will trade it.

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Wouldn't it be great to have a big pile of gold? If you didn't have that, the next best thing would be to have mining rights to two of the largest gold mines in the world, Venezuela's Las Cristinas 4 and 6, aka Kilometre 88. If you didn't have that, the next best thing would be to have an indirect interest in a private company with an undisclosed agreement with a company that bought the rights from three guys who had been caught 12 years earlier attempting to transfer the mining rights to themselves fraudulently through a revoked power of attorney made with a dying woman who was suing to get the rights from someone else and these three guys settled charges against them by a formal court stipulation that they had no claim to the rights and would not sue in future to get them; and whoever actually had owned the rights, they had been extinguished nine years earlier by the Venezuelan Ministry of Energy and Mines, after which the legally recognized mining rights were sold to Canadian mining company Placer Dome and the Venezuelan state mining company, which were in fact mining the gold.

A company called Cyrstallex (KRY) peddled this asset to public shareholders for $300 million. Rather than a standard public offering, insiders issued shares to themselves, then resold them to the public at hefty mark-ups. The "mining rights" were purchased via a $13.7 million "loan" (no interest, no repayment schedule) to a private company owned by the insiders which then signed the undisclosed agreement with the company that had a deal with the three heroes who already signed away their dubious claim to the dubious asset to settle fraud charges. The stock price was maintained by company press releases claiming ownership of the mining rights. When that wore thin, Crystallex claimed instead that it was filing in the Venezuelan Supreme Court to get those rights.

In fact, the action filed was to overturn the earlier stipulation not to sue for the rights. That pleading was emphatically denied. If it had somehow been successful, Crystallex theoretically could have reopened the transfer case. Since that had already be argued, and not only had the transfer been ruled invalid but the plaintiffs had barely escaped fraud prosecution for

bringing the case in the first place, it's difficult to be optimistic about the outcome. Assuming the transfer was somehow validated, there were still the small matters of actually winning the case the now-deceased woman had brought, and also persuading the Venezuelan Ministry of Energy and Mines to overturn its extinguishment of the rights. Getting that far would have freed Crystallex to bring a case against Placer Dome and the Venezuelan state mining company. Win that, and they would have been free to dig for gold. Okay, that's a risky asset to buy for $300 million, but all stocks have risk. You take a risk when you get out of bed in the morning. Just think, if you won the rights they could be worth $116 million (that's what Placer Dome valued them at, including all their equipment and improvements, before writing them down to zero due to falling gold prices).

Asenio Hall of Shame

This case is one of about two dozen discussed by famous short-seller Manuel Asensio in his new book Sold Short. Asensio shorted Crystallex, then issued a series of research reports debunking their claims and bringing the share price down from $8.31 to $0.38. To be precise, the market brought the price down, Asensio just helped it happen faster.

So far, this is an amusing story (if you didn't invest in Crystallex, that is). Everyone knows stock scams and gold mines gotogether, and there are plenty of fast talking promoters with more chutzpah than facts. What makes this story and the others in the book really scary is the number of big name institutions that bought into the Crystallex scam, and continued to buy in after the facts had been thoroughly publicized. Today, three years after even the densest investor must have realized Crystallex will never get a nugget from Las Cristinas, Hoovers and most online sites still list those mining rights as the company's main asset.State Street Research, Wells Fargo, JP Morgan Chase, Morgan Stanley, Bear Stearns, Merrill Lynch, Legg Mason, Fleetboston and Firstar still own shares. You can visit the KRY Yahoo! message board to see heartbreaking examples of small investors who still believe.

Equity analyst Kenneth Friedman wrote in a 1997 report: "The Venezuelan Supreme Court has issued several rulings which give Crystallex the rights to Cristinas 4 and 6." The actual court ruling came five days after the report and denied Crystallex's petition to overturn the stipulation, thoroughly quashing the faintest hope of value for the stock. Still, John Attaliental of Barrow Street Research put a Strong Buy on the stock two weeks after that ruling, and reiterated it seven months later. Four large mutual fund companies, including Fidelity and Scudder, bought large positions for their precious metals funds after the case had been lost. Roy Carson reported that Placer Dome had offered $23 per share for Crystallex, but the company turned it down because other bidders had offered more. He later reported that Placer Dome was about to give up the "fight" and turn the rights over to Crystallex. Placer Dome CEO John Willson angrily denied both stories, as well as another brokerage firm report that had Placer Dome offering Crystallex a partnership in the Las Cristinas project.

Dorothy Atkinson with Whalen, Beliveau & Associates put a $25 price target on Crystallex and, echoing Richard Nixon, wrote: "Crystallex is not a fraud, there is a court case ongoing, and that is why senior banking companies aren't making loans to Placer.. . . Concessions Cristinas 4 and 6 acquired by Crystallex constitute ownership rights that are recognized and protected under Venezuelan mining law and have been confirmed by the Supreme Court of Venezuela and leading Venezuelan law firms." Left out of the report (in addition to why rights have to be confirmed by "leading law firms" in addition to the Supreme Court) was that her firm received $1.7 million cash and 10 million warrants from Crystallex for arranging institutional

financing, and was busy selling a million shares of Crystallex stock at under $5 per share (casting doubt on the sincerity of the firm's belief in its $25 target).

White shoe shaft

Crooks are one thing, and you will meet many of them, of all stripes, in this book. Equity analysts who write glowing research reports without even the sketchiest due diligence are quite another. Mutual fund companies that buy worthless stocks, when five minutes of research would reveal the facts, are even worse. More disturbing still is the way Wall Street closes ranks and lets fraud flourish rather than admit error. Hundreds of millions of investor dollars are collected and delivered to individuals with long histories of stock manipulation and fraud. The underlying companies either don't have a product at all, or claim a product they do not have the rights to, or hawk a failed drug or invention that resurfaces every few years as the solution to whatever problem is in the headlines. Wall Street would rather let people think it's crooked than that most equity analysts don't bother to look at the products of the companies they cover and wouldn't know how to evaluate those products if they did. Analysts repackage management stories to curry favor for institutional business, mutual funds scarf up what the brokerage firms push in hopes that continued pushing will inflate short-term performance (or sometimes in exchange for direct consideration like cash or below-market stock).

When Asensio assembled evidence that Dreyfus portfolio manager Michael Schonberg had participated in stock fraud for personal gain, parent Mellon Bank didn't want to hear about it. In nine separate instances, Schonberg purchased large holdings of tiny companies for himself, then pumped up the price by buying more shares of the same companies for his funds. One example was Color Chromatic Sciences International (CCSI), which claimed to have developed a Food and Drug Administration approved non-invasive device to monitor jaundice in newborns. In fact, it was an off-the-shelf color monitoring device hooked up to a Toshiba computer, inferior to dozens of other products already on the market. When CCSI hit $19, Asensio issued a "strong sell" arguing that the firm's product would never sell, its principal business was defrauding investors, and that the stock was worth less than a dollar (its final sale, before the Nasdaq stopped trading, was less than a dime). Another example was Systems of Excellence (SEXI) described in my commentary on Internet stock fraud.

On June 16, 1998, Asensio wrote to Mellon's CEO to detail the evidence that Schonberg was foisting worthless stocks on Dreyfus fund shareholders in order to make personal trading profits. He got a reply from Mellon's counsel, Michael Bleier. "Mellon will not be drawn into your press campaign," Bleier sputtered, then hired the law firm of Rogers & Wells to accuse Asensio of comments that were "false, defamatory and actionable." Had Mellon instead investigated the charges, it might have saved a $950,000 fine (plus investigation costs, plus a $1.6 million donation to the State University of New York for investor education), not to mention the tens of millions of dollars Schonberg cost Dreyfus shareholders or the tens of thousands Mellon paid Rogers & Wells.

The problem extends beyond the brokers and managers. Governments, including the State of New Jersey, the Province of Ontario and the US federal government, may side with the bad guys. (By contrast, the government of Venezuela helped quash Crystallex.) New Jersey awarded one of the largest state construction projects in history, the $488 million EZ-Pass conversion, to an insubstantial company that pocketed the state's money, hired subcontractors to do the work and didn't pay them, then used the contract to issue overpriced stock to public investors. Despite Asensio's extensive documentation of the problem, and adequate contractual safeguards to cancel the contract and collect damages from the performance bonds, New Jersey

stuck by their contractor. The NASD and the stock exchanges tolerated transparent stock manipulation and maintained listing for stocks steeped in sleaze. Top business publications wrote company puff pieces and downplayed or ignored the facts assembled by Asensio.

If you have any illusions about stock market purity, this book will shatter them. The fraudulent promoters have at least a whiff of romantic dreams to disguise their crimes: breakthroughs in diagnosis or treatment of disease, solutions to energy shortages, businesses in exotic (ie, hard to audit) locales. The Wall Street boosters, and their lawyers who mount baseless lawsuits against the truth-tellers to protect the liars, don't even have that.

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