# Economic Warfare: Risks and Responses

## Analysis of Twenty-First Century Risks in Light of the Recent Market Collapse

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# Executive Summary

**Serious risks to the global economic system were exposed by the crisis of 2008, raising legitimate questions regarding the cause of the turmoil. An estimated $50 trillion of global wealth evaporated in the crisis with more than a quarter of that loss suffered by the United States and her citizens.**

A number of potential causative factors exist, including sub-prime real estate loans, a housing bubble, excessive leverage, and a failed regulatory system. **Beyond these, however, the risks of financial terrorism and/or economic warfare also must be considered. The stakes are simply too high for these potential triggers to be ignored.**

The Obama administration's recent call for greater financial regulation stipulates to the facts that hedge fund activity has been virtually unregulated and that dark-pool trading, Credit Default Swaps, and naked short selling provide tremendous vulnerabilities in the system. This report concurs with these concerns as recently outlined by the heads of the SEC, US Treasury, and Federal Reserve and provides supporting data. **Beyond that, this report exposes the fact that these vulnerabilities are subject to exploitation not only by greedy capitalists seeking profit but also by financial terrorists, intent on destroying the American financial system.**

From a historical perspective, there are numerous examples of financial attacks on specific companies and industries both for economic and non-economic reasons. In addition, there are other examples of financial attacks conducted against individual nations both for economic and non-economic reasons. Based on this awareness, the economic collapse of 2008 must be critically examined to determine the possibility that a financial attack took place as well as an assessment of future risks.

**The purpose of this report is to consider the implications of financial terrorism and/or economic warfare and to identify and realistically list prospective threats to U.S. economic security from a means, motive, and opportunity perspective.**

The preliminary conclusions of the research suggest that, without question, there were actors who had the motive to harm the U.S. economy. These motives can be categorized as both economic and non-economic. In addition, these same actors have clearly demonstrated the means to carry out such an attack. Finally, the opportunity was clearly present given the existing economic condition and regulatory framework in operation.

The hypothesis under consideration is that a three-phased attack is underway with two of those phases completed to date.

- **The first phase was a speculative run-up in oil prices that generated as much as $2 trillion of excess wealth for oil-producing nations, filling the coffers of Sovereign Wealth Funds, especially those that follow Shariah Compliant Finance.** This phase appears to have begun in 2007 and lasted through June 2008.

The rapid run-up in oil prices made the value of OPEC oil in the ground roughly $137 trillion (based on $125/barrel oil) virtually equal to the value of all other world financial assets, including every share of stock, every bond, every private company, all government and corporate debt, and the entire world's bank deposits. That means that the proven OPEC reserves were valued at almost three times the total market capitalization of every company on the planet traded in all 27 global stock markets.

- **The second phase appears to have begun in 2008 with a series of bear raids targeting U.S. financial services firms that appeared to be systemically significant.** An initial bear raid against Bear Stearns was successful in forcing the firm to near bankruptcy. It was acquired by JP Morgan Chase and the systemic risk was averted briefly. Similar bear raids were conducted against various other firms during the summer, each ending in an acquisition. The attacks continued until the outright failure of Lehman Brothers in mid-September. This created a system-wide crisis, caused the collapse of the credit markets, and nearly collapsed the global financial system.

  The bear raids were perpetrated by naked short selling and manipulation of credit default swaps, both of which were virtually unregulated. The short selling was actually enhanced by recent regulatory changes including rescission of the uptick rule and loopholes such as "the Madoff exemption."

  While substantial, unusual trading activity can be identified, the source of the bear raids has not been traceable to date due to serious transparency gaps for hedge funds, trading pools, sponsored access, and sovereign wealth funds. What can be demonstrated, however, is that two relatively small broker dealers emerged virtually overnight to trade *"trillions of dollars worth of U.S. blue chip companies. They are the number one traders in all financial companies that collapsed or are now financially supported by the U.S. government. Trading by the firms has grown exponentially while the markets have lost trillions of dollars in value."*[1]

- **The risk of a Phase Three has quickly emerged, suggesting a potential direct economic attack on the U.S. Treasury and U.S. dollar.** Such an event has already been discussed by finance ministers in major emerging market nations such as China and Russia as well as Iran and the Arab states. A focused effort to collapse the dollar by dumping Treasury bonds has grave implications including the possibility of a downgrading of U.S. debt forcing rapidly rising interest rates and a collapse of the American economy. In short, a bear raid against the U.S. financial system remains possible and may even be likely.

Phase Two may have concluded with the brief market rebound that was supported by an emerging regulatory response calling for greater transparency across the board. Efforts including regulation of credit default swaps and proposed oversight of previously unmonitored trading activity, as well as Federal support of systemically vital institutions. **But, we remain left with the critical unanswered questions of who and how?**

**The recent seizure of $134 billion face value in supposedly counterfeit U.S. Federal Reserve bonds underscores the reality of the economic threat. This may be as significant as the Japanese radio intercepts were before December 1941.**

**Immediate consideration of the issues outlined in this report is vital.  Further study is essential and prospective responses must be crafted to address future risks. Finally, there are legitimate questions about the performance of the regulatory regime and Wall Street institutions. Implications that these parties have been complicit or otherwise co-opted cannot be ruled out. Therefore, it is strongly recommended that this study and any task-force response be conducted outside of traditional Washington and Wall Street circles.**

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# Introduction

The economic events of 2008 have been compared with those of the 1930s. Warren Buffett described the initial market decline as an "Economic Pearl Harbor."[2] Regardless of the perspective or cause, the severe economic weakness experienced in 2008 and early 2009 may be categorized as a serious crisis, both national and international in scope.

Within a matter of weeks, an estimated $50 trillion of global wealth virtually vanished. At least $15 trillion of that loss was experienced by Americans, as measured by the combined declines in the value of stocks, bonds, real estate, and other assets.

The possible origins of the economic turmoil are multiple and diverse, including sub-prime real estate, a housing bubble, excessive leverage, and a failed regulatory system. **While each of these no doubt played a significant role, legitimate questions should be raised regarding other potential triggers including criminal or terrorist activity as well as economic warfare.**

There is no question that the impact of the economic collapse has raised to the level of a national security threat. Not only does it strike at the heart of American productivity but also to her ability to finance future growth and defense. Unfortunately, based on interviews with members of the defense and intelligence community, it appears that the economic threat, while very real and advanced, may have been unrecognized even as the economy was collapsing.

Given the economic and security implications, it is imperative that all possible causes and triggers be effectively examined to determine existing and future risks. This paper offers a preliminary review of these considerations and provides recommendations for additional study along with potential appropriate responses.

It should be noted that the Obama administration has very recently acknowledged the serious gaps in the regulatory framework that have left the American financial system vulnerable. These gaps include virtually no oversight of dark trading pools, credit default swaps, hedge funds, and naked short selling. There should be no doubt that these gaps were exploited and this, at a minimum hindered financial system stability (and possibly triggered the entire crisis). While calls to address these gaps are essential, without knowing who exploited them and why, the system will remain vulnerable through currently unidentified mechanisms.

**This paper explores the hypothesis that a three-phased economic attack has now entered the third and most critical phase. The serious concern is that available resources will be focused exclusively on addressing the vulnerabilities of the just completed Phase Two. While this is necessary and essential, it is insufficient. It is tantamount to fighting the last war. Preparation must be made now to address Phase Three.**

# Background and Timeline of Events

## Global Economic Peak

As recently as late 2007, many experts were proclaiming that the world had entered a new and unprecedented era of extraordinary prosperity. The consensus viewpoint was predicting consistent annual global GDP growth in the 3.5% range with projections of annual growth averaging as high as 6% by 2050. These optimistic forecasts were predicated on a belief that globalization and the spread of democratic opportunity would allow a "rapid upliftment of all metrics of human development."[3]

In hindsight, there were obviously some serious economic issues brewing in 2007. At the time, however, a majority of economists were positive and the April 2007 IMF forecast was for 4.9% annual growth. Their best economists said that there was about a 20% chance for global growth below 4% in 2008. [4]

The beginning of the economic difficulties can be traced to two factors that occurred simultaneously, both driven by a combination of loose monetary policy combined with bubble-like speculation. Loose money allowed individuals to buy houses with low interest rates. Loose money also supported a firming in materials prices. The two fed on each other, creating a bubble-like atmosphere.

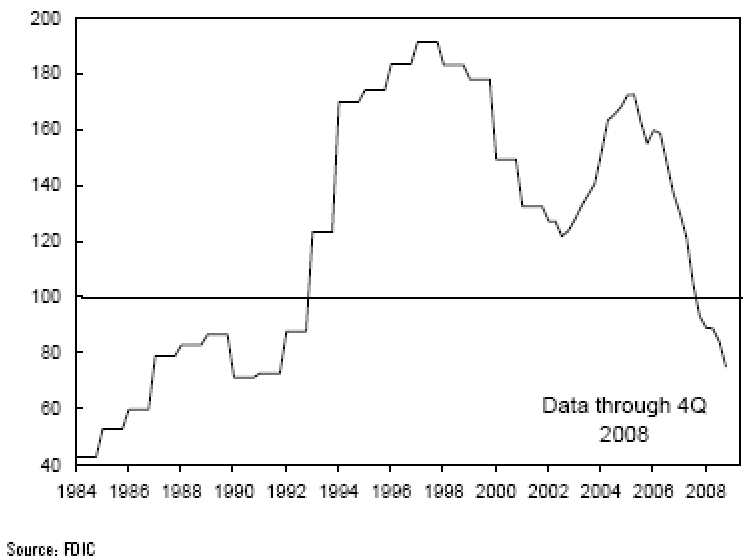
## The Housing Bubble

Home prices advanced for two primary reasons. First, the cost to produce housing increased with higher raw materials prices and increased labor costs. At the same time, loose monetary policy with lower interest rates increased demand. This combination produced higher prices, which in turn had two effects. The first made the existing stock of homes more valuable. With the advent of Home Equity Lines of Credit (HELOCs), this added further to available money supply as individuals were able to borrow against their homes. The second effect was that higher prices made housing appear to be one of the best performing investments. Unfortunately, as the trends accelerated, a bubble was formed that would eventually burst.

Investors sought to buy more housing than they needed for personal use. This meant bigger and more expensive homes as well as multiple investment properties. The housing boom further pressured the cost of raw materials. In some cases, speculators would buy and sell prospective condominiums even before construction had begun. This created a housing glut that hangs over the market today.

The other economic impact was a shifting of investment priorities away from other areas to housing and mortgages. This was the inception of the so-called "toxic assets," blamed for the collapse of the financial system. There is little doubt that non-performing assets held on bank balance sheets became a serious economic problem as seen in the following graph.

**Ratio of Bank Loan Loss Reserves to Non-Performing Assets**




Source: "Just How Poisonous is a Toxic Asset?", *Citi Research*, 6 April 2009, p.4 [5]

[It should be noted that while non-performing loans exceeded the bank loan loss reserves during the crisis, the situation is far from unprecedented. In fact, reserves at the end of 2008 were significantly higher relative to loan non-performance than in 1984 and roughly in line with the 1984-1994 average, a period of general economic prosperity.]

## Oil Price Spike

Starting from a low in January 2007 near $50/barrel, oil prices began a steady and unrelenting rise to almost $150/barrel by June 2008. This virtual tripling of price occurred even as economic growth appeared to be leveling and drilling activity increased. At the time there was a serious debate between those who claimed speculation was the primary cause of higher prices and those who claimed they were caused by natural supply/demand forces. In hindsight, the largest increase in prices without a supply disruption in decades does appear to have been, at least in part, driven by speculation.

The Center for Energy and Environmental Policy Research CEEPR), a joint project between MIT and the Sloan School of Management published research by MIT's Professor of Economics Emeritus, Richard S. Eckaus on 13 June 2008 titled, *"The Oil Price Really is a Speculative Bubble."*[6]

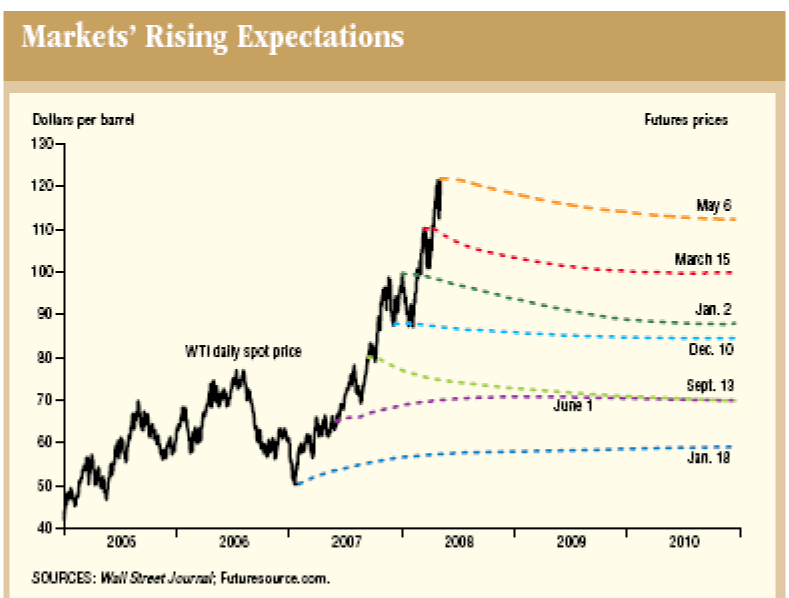
The abstract opens with the following:

> *"The oil price really is a speculative bubble. Yet only recently has the U.S. Congress, for example, showed recognition that this might even be a possibility. In general there seems to be a preference for the claim that the price increases are the result of basic economic forces: rapid growth in consumption, pushed particularly by the oil appetites of China and India, the depreciation of the U.S. dollar, real supply limitations, current and prospective and the risks of supply disruption, especially in the Middle East. These explanations will be taken up one by one, but first a view of what has happened to oil prices over recent years."*[7]

After factually dismissing each of the "explanations" mentioned, the paper concludes with the following:

> *"Since there is no reason based on current and expected supply and demand that justifies the current price of oil, what is left? The oil price is a speculative bubble. This is an idea that has some backing in financial circles, e.g. George Soros. The spiking price pattern would, itself, suggest it. It is well known that hedge funds are very active in the oil market and their activity, along with other speculators, has raised the volume of oil transactions far above the volume warranted by ordinary commercial transactions."*[8]

In hindsight, it appears that Professor Eckaus was at least partially on target. Unlike the housing bubble, which had some short-term positives for the domestic economy, the oil price spike was largely negative for America (although beneficial to oil-producing states). It put a drag on household income, crowding out spending for other items. As prices increased into June, ultimately reaching near $150/barrel, consumers began to panic. The chart below shows that market expectations increased steadily along with the price hikes.




Source: Federal Reserve Bank of Dallas[9]

## Bear Stearns Collapse

Bear Stearns, until recently the fifth largest U.S. investment bank, was a firm that had survived the Great Depression, World War II, the 1987 market crash and the terrorist attack of 9/11. Yet, the firm collapsed in March 2008. On January 12, 2007, the firm's stock traded at $171/share. A little more than a year later, on March 16, 2008, JP Morgan agrees to buy Bear for $2/share (the tender offer was later raised to $10/share).

In hindsight, SEC Chairman Christopher Cox attributed the collapse of Bear Stearns to "market rumors" about liquidity that became self-fulfilling. This was in spite of the fact that Bear Stearns operated with sufficient capital in excess of regulatory standards with a liquidity pool of as much as $18.1 billion on March 10, 2008.

Clearly, the rapid collapse of Bear Stearns hurt the market and economy overall and was considered a sufficient threat for the Federal Reserve to seek a buyer for the firm.

## The Collapse of Fannie and Freddie

During the summer of 2008, pressures mounted against Fannie Mae and Freddie Mac, two government sponsored entities (GSE's) that are most connected to housing. For decades, these two created opportunity for Americans to live out the dream of home ownership. In light of the housing bubble, however, the two became overextended and the target of short sellers. The stock of Fannie Mae, that rested above $60 in late 2007 dropped to $10/share on its way to below $1 by September 2008. The share price of Freddie Mac followed an identical pattern. The Treasury had to inject tens of billions of dollars to prop up the two, eventually providing a full-scale bailout.

The situation was markedly complicated by the collapse in Fannie and Freddie's stock price along with the massive rise in the cost to insure their debt. This hampered the ability to raise additional capital and created a situation of near chaos, further exacerbating the housing market.

The situation was dire, as explained by an NPR report on 9 September 2008 titled *Global Nightmare: If Fannie and Freddie Had Failed:*

> *…economists argue that the cost of not saving Fannie and Freddie would have been far, far greater. Together, the agencies hold loans of $5 trillion. That's the largest debt ever held by any private company in history. It's larger than any other country's debt, with the exception of that of the United States. Allowing Fannie Mae and Freddie Mac to collapse would have been akin to letting Japan or the United Kingdom go bankrupt. Global economic leaders say even those unimaginable scenarios would have paled beside the fallout from a Fannie/Freddie implosion.*[10]

> *"The bankruptcy of Fannie and Freddie would have meant Armageddon," said Domenico Siniscalco, former finance minister of Italy. He added, "Meltdown of the financial system, the global financial system."*[11]

[In hindsight, the saving of Fannie and Freddie merely shifted the attacks to other targets and the failure of Lehman Brothers triggered at least part of the Doomsday Scenario that was outlined. In terms of Fannie and Freddie, the government's seizure injected needed capital while explicit government backing of their debt has provided stability. At present, the Administration is counting on a vibrant Fannie and Freddie to support the housing market and serve as an agent for mortgage lending reform.]

## The Events of September 2008

In rapid-fire fashion, financial firms were under attack by short sellers beginning around 11 September 2008. The government seized control at Fannie Mae and Freddie Mac but allowed Lehman Brothers to fail. Subsequent concerns were raised regarding virtually every financial firm including Merrill Lynch and Washington Mutual (which were eventually merged into other banks), Citigroup, Bank of America, and even Goldman Sachs. This led to a virtual shut down of the credit system, the "doomsday scenario" outlined earlier that was served as the fear basis for saving the GSEs (government-sponsored enterprises). Derivative implications included an inability for consumers to get loans to buy big-ticket items and for businesses to get capital needed for operations and expansion. This, in turn, severely impacted economic activity, causing a direct downturn in GDP, sparking depression and deflation fears.

The stock market reacted violently with losses exceeding 50% from peak to the lows of early 2009. The government embarked on a variety of rescue programs including the $700 billion TARP (Troubled Asset Relief Program) and a total of $12.8 trillion in rescue packages plus fiscal/monetary stimulus. The ultimate impact went far beyond Wall Street with notable failures such as General Motors (as auto sales dwindled to historic lows) and major retailers. Unemployment skyrocketed from historic lows to levels unseen since the early 1980s. Tax collections have dropped sharply and government debt has risen dramatically.

## Understanding the Potential Factors behind the Crisis

There are many legitimate explanations for the crisis and each has some degree of merit:

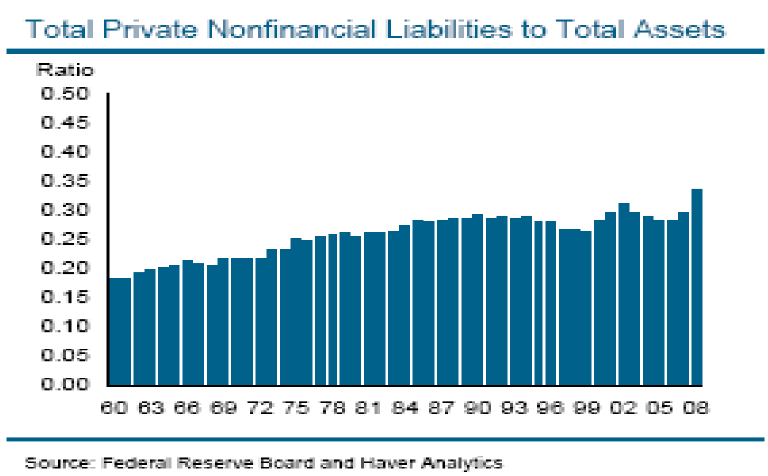
1. **Excessive debt/leverage**

   There is no question that the high levels of debt contributed to the crisis. In some cases, there are attempts to primarily blame the crisis on high debt levels. Alarmists point to charts that show increases in the level in non-financial debt to Gross Domestic Product and accurately note that the ratio is the highest in history. In very rough numbers, this ratio was approximately 2.3 times nominal GDP, up from 1.4 times in 1980.

Much of the blame for this problem has been laid at the feet of an extremely easy monetary supply by the Federal Reserve following the technology bubble and the terror attacks of 2001. Some economists believe that interest rates were kept too low for too long encouraging excessive debt-driven speculation.

On its face, this argument appears quite compelling. Despite having some merit, however, the logic is far from complete. The primary issue is that the ratio compares total debt to annual income. It ignores the term of the debt and also the value of the assets behind the debt. The term of the debt is significant because longer maturity debt typically has less impact due to smaller required payments. As a basic example, a $50,000 car loan with a 3-year term would require nearly $1,400 in monthly principal payments while a 30-year mortgage would have monthly principal payments of less than $140. According to research from Alliance Bernstein, approximately 70% of outstanding debt today is considered "long term" as compared to 55% in 1980.[12]

The second problem with basic debt to GDP analysis is that it ignores the asset levels supporting the debt. Using the previous example, a car loan of $50,000 has a greater negative wealth effect than a $50,000 mortgage if the car is expected to depreciate while the home has the potential to appreciate over time. In addition, a higher level of assets supports a greater level of debt even if income lags. In this case, the much more important ratio is the comparison of debts to assets. Looking at Federal Reserve data, this ratio, while rising, has been reasonably stable over time. The seemingly dramatic jump in 2008 is explained, in part, by the dramatic short-term drop in assets such as home prices and stock portfolios. Without these sharp declines, the ratio in 2007 is not far from the ratios that prevailed between 1980 and 2000.




Source: Alliance Bernstein research[13]

Debt clearly played a part in the crisis but cannot be viewed as the sole issue. Instead, the debt levels should be viewed as creating vulnerability subject to exploitation.

2. **Ineffective / Laxly Enforced Regulation allowing Speculation**

Another serious issue has to do with ineffective and unenforced regulation. A vast regulatory framework was created in the 1930s in an attempt to prevent a repeat of the Great Depression. During the past decade, much of this framework was dismantled including a partial repeal of the Glass-Steagall Act of 1933 in 1999 and rescinding the 1938 "uptick rule" in 2007. Removing the former in 1999 eliminated some safeguards that prevented commercial banks from becoming overleveraged as investment banks. Ultimately, this allowed consumer banking functions such as deposits and consumer loans to be tied to investment banking leverage. Removing the "uptick rule," eliminated a safeguard designed to prevent "bear raids" on companies (which will be discussed in detail later in this paper).

In addition, most observers agree that the regulatory system designed for a 1930s economy had become outmoded. As an example, modern financial instruments such as Credit Default Swaps, Hedge Funds, and Exchange Traded Funds have grown substantially over the past decade but in large part left out of the regulatory structure. Even those entities and instruments subject to regulation have been able to operate in a variety of gray areas with multiple regulators. The primary impact of this has been to make the system less transparent and more vulnerable.

Observers view the primary problem of absent regulation being the encouragement of excessive levels of risk-taking and speculation. There is some merit to this view, no doubt. **The other side of that same coin, however, is that lax regulation may well have provided vulnerability to economic attack as discussed later in this paper.**

3. **Part of a normal market cycle?**

The third explanation made for the collapse of 2008 is based on the concept of normal market cycles. Economies tend to move from expansion to recession and then expansion. While the Federal Reserve has attempted over time to mute the cycles, they ultimately resurface. Some economists even believe that the cycles can be at best postponed. In this view, when the recession ultimately arrives, it will be more difficult than if left to occur naturally. Likewise, stock markets tend to move from bullish to bearish and then bullish.

A strong case can be made that the economy was due for a recession at some point in the 2008-2010 timeframe. Likewise, the stock market had gone several years into 2007 without a 10% correction, let alone a 20% or greater bear market. The real question to consider is if an economic/market downturn were due, how severe would it be?

Several measures demonstrate that the severity of the 2008 crisis exceeds every downturn since the Great Depression, including the severe recession of 1973-74. Was such a downturn warranted? Or, perhaps were there exogenous forces at work that magnified the difficulties?

4. **Outside forces at work**

   There is sufficient justification to question whether outside forces triggered, capitalized upon, or magnified the economic difficulties of 2008. This paper examines possible sources and impacts of those outside forces. All other things being equal, the economy and markets may have suffered a normal downturn, but it would likely have been more of the magnitude of a serious recession coupled with a bear market as have been endured multiple times over the past 70 years. The near collapse of the global economic system with a corresponding depression that would have dwarfed the 1930s, however, seems excessive to the expected economic weakness. Yet, there we stood in September 2008.

# Hypotheses for Consideration

From an investigatory standpoint, there are three possible hypotheses to consider regarding the economic collapse of 2008:

1. **Natural/Inevitable**

   That the economic crisis was a natural evolution of existing market trends and circumstances. From this view, the markets were due to crash with a corresponding economic interruption.

2. **Profit-Driven**

   That the economic crisis was likely inevitable but hastened by economic-driven actors using non-traditional, albeit legal, means to expose and profit from the weakness at a firm or industry level. The correspondent disruption was an inadvertent side-effect.

3. **Financial Terrorism/Economic Warfare**

> That the economic crisis was an intended purpose of a specific financial attack perpetrated by one or more actors driven by a combination of motives.

Each of these three propositions has merit for consideration as well as implications for policy response. None can be ruled out as impossible based on a review of the existing evidence. The truth may well be that a combination of forces were at work. **The fact that there is reasonable credibility assignable to Hypothesis 3 justifies very serious consideration.** This hypothesis is certainly the most complex of the three and carries with it the most serious implications. **It therefore requires the greatest focus and is the primary subject of this report. In understanding the possibility of financial terrorism/economic warfare, it is essential to review how such attacks may occur.**

## The Risk of Financial Terrorism/Economic Warfare

Examining both the timeline and potential causative factors, two basic events stand out as possible acts of economic attack. The first is the speculation in the oil market which produced dramatic price increases into the summer of 2008 with the second being the dramatic declines in financial stocks that followed. While the housing bubble and debt buildup clearly had dramatic impacts in their own right, it is hard to conceptualize how such events could be the result of an economic attack. Rather, they would seemingly represent vulnerabilities to be exploited.

## Phase One: Oil as a Weapon to Raise Capital

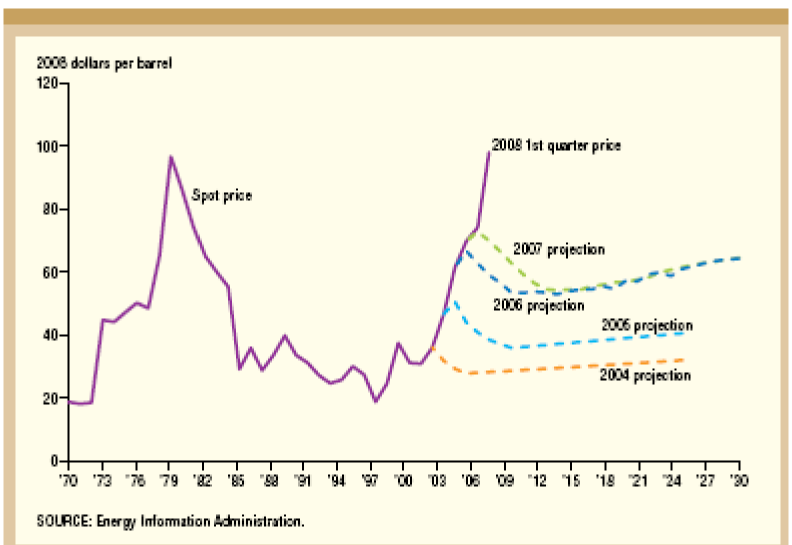
Since the original oil embargo in 1967, used to deter support for Israel during the Six-Day War, oil has been viewed globally as a potential economic weapon. While the first embargo was largely ineffective, the second, occurring in 1973, had a greater impact. The following is an analysis from the U.S. Department of State:

> *"The Second Arab Oil Embargo, which lasted from October 1973 to March 1974, posed a major threat to the U.S. economy. Moreover, the Nixon Administration's efforts to address the effects of the embargo ultimately presented the United States with many foreign policy challenges.*
>
> *During the October 1973 Arab-Israeli War, the Arab members of the Organization of Petroleum Exporting Countries (OPEC) announced an embargo against the United States in response to the U.S. decision to re-supply the Israeli military during the war. Arab oil producers also extended the embargo to other countries that supported Israel. The embargo both banned petroleum exports to the targeted nations and introduced cuts in oil production. Several years of negotiations between oil producing nations and oil companies had already destabilized a decades-old system of oil pricing, and thus the Arab oil embargo was particularly effective.*

> *Implementation of the embargo, and the changing nature of oil contracts, set off an upward spiral in oil prices that had global implications. The price of oil per barrel doubled, then quadrupled, leading to increased costs for consumers world-wide and to the potential for budgetary collapse in less stable economies. Since the embargo coincided with a devaluation of the dollar, a global recession appeared imminent. U.S. allies in Europe and Japan had stockpiled oil supplies and thus had a short term cushion, but the longer term possibility of high oil prices and recession created a strong rift within the Atlantic alliance. European nations and Japan sought to disassociate themselves from the U.S. Middle East policy. The United States, which faced growing oil consumption and dwindling domestic reserves and was more reliant on imported oil than ever before, had to negotiate an end to the embargo from a weaker international position."* [14]

Oil was also considered an effective weapon in the 1979 Iranian revolution and hostage-taking. This completed a near decade of higher oil prices and a peak that would not be surpassed in inflation-adjusted terms for nearly three decades.

**Long-Term Nominal Oil Spot Prices**




Source: Federal Reserve Bank of Dallas [15]

There should be absolutely no doubt that oil was considered a weapon, and in fact a very effective one, during the 1970s. Based on the chart, however, the price breakout above $40 that took place in 2004 represents perhaps the first time in a quarter century that the oil weapon could be considered a real threat. There was a minor run up during the first Gulf War but was quickly squashed by Saudi Arabia in the effort to support the freeing of Kuwait from Saddam Hussein. In looking at the supply/demand data as well as growth forecasts at the time, it appears that price increases into early 2007 were justified by basic economics. Oil traded in a range between $50 and $75 per barrel until late 2007 when the price went straight up an additional $75 in about nine months starting at the end of 2007 and running through June 2008.

According to Professor Eckaus (MIT):

> *"Although the influences behind price movements cannot be determined simply by looking at the price record, the record can be suggestive. Thus, it is tempting to believe that something big happened in 2004 to create a definite upward push to prices and then, again in 2007. In 2007 and the first six months of 2008, something even bigger was pushing up prices even more rapidly. What could the "something big" be? A powerful demand push? A major supply constraint?* ***Or, the suspicion must emerge, that the price movements in 2007 and after look suspiciously like other speculative price movements.*** *Think pork bellies."* [16]

Given that introduction, it is important to recall the paper's conclusion (after ruling out all other possibilities):

> *"Since there is no reason based on current and expected supply and demand that justifies the current price of oil, what is left? The oil price is a speculative bubble. This is an idea that has some backing in financial circles, e.g. George Soros. The spiking price pattern would, itself, suggest it. It is well known that hedge funds are very active in the oil market and their activity, along with other speculators, has raised the volume of oil transactions far above the volume warranted by ordinary commercial transactions."* [17]

In order to further examine what has been termed "Phase One" of this hypothesis, it is necessary to dig behind the understood truth that speculation was at work to determine the who, how, and why.

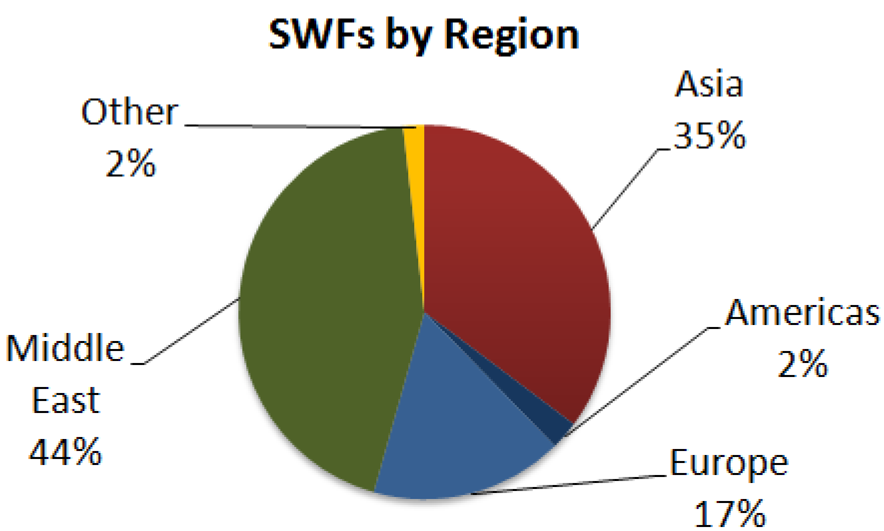
The most likely suspects in an oil price shock are naturally those who would benefit most from higher prices. It is possible that such activity was undertaken as a speculation solely for profit by hedge funds. The risk they would take, however, would include the very real possibility of geopolitical maneuvering. This was the reality from 1980 until very recently where Saudi Arabia was supportive of U.S. economic policy. Even during the first Gulf War, prices were maintained at reasonable levels despite lost production from both Kuwait and Iraq. Many have likewise speculated that the Saudis helped lower oil prices to bring about the demise of the Soviet Union. Therefore, for most of the period from 1980 until 2004, hedge funds and others were reticent to try and drive oil prices substantially higher in a speculative action.

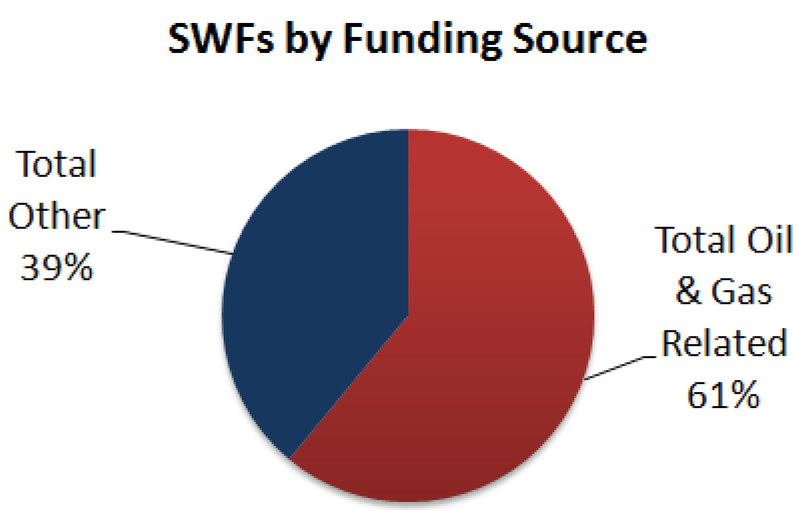
What appears to have changed around 2004 is that sentiment in oil-producing nations may have turned more negative based on U.S. involvement in Iraq, at least on the streets. In this respect, the sentiment may simply have turned neutral toward U.S. policy and instead of providing support through lower prices, the oil producers would seek to maximize revenues. In doing so, they would certainly benefit from and thereby support higher oil prices even if through speculation.

In this view, hedge funds would be viewed as a mechanism to achieve higher prices through oil trading rather than the primary causation.

The Phase One theory actually begins with the oil producers using a relatively new and rapidly growing mechanism known as Sovereign Wealth Funds (SWF). According to the Sovereign Wealth Fund Institute:

- ***"A Sovereign Wealth Fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets.*** *These assets can include: balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports."* [18]
- ***"Since 2005, at least 17 sovereign wealth funds have been created.*** *As other countries grow their currency reserves they will seek greater returns. Their growth has also been skyrocketed by rising commodity prices especially oil & gas, especially between the years of 2003 – 2008."* [19]




Source: SWF Institute

According to testimony from Dr. Gal Luft, Executive Director of the Institute for the Analysis of Global Security (IAGS) presented before the House Committee on Foreign Affairs:

> *"The rise of sovereign wealth funds (SWF) as new power brokers in the world economy should not be looked at as a singular phenomenon but rather as part of what can be defined a new economic world order. This new order has been enabled by several megatrends which operate in a self-reinforcing manner, among them the meteoric rise of developing Asia, accelerated globalization, the rapid flow of information and the sharp increase in the price of oil by a delta of over $100 per barrel in just six years which has enabled Russia and OPEC members to accumulate unprecedented wealth and elevate themselves to the position of supreme economic powers. Oil-rich countries of OPEC and Russia have more than quadrupled their revenues, raking some $1.2 trillion in revenues last year alone. At $125 a barrel oil they are expected to earn close to $2 trillion dollars in 2008."* [20]

Clearly, the SWFs have an economic motive to drive oil prices higher. They also have the means to do so. Again, according to Dr. Luft:

> *"In this context, we should view SWF as enablers of the new economic order. SWF are pouring billions into hedge funds, private equity funds, real estate, natural resources and other nodes of the West's economy. No one knows precisely how much money is held by SWF but it is estimated that they currently own $3.5 trillion in assets and within one decade they could balloon to $10-15 trillion, equivalent to America's gross domestic product."* [21]

The opportunity came from the manner in which oil prices are set, on a global basis, through non-transparent trading that has been regulated outside the United States. These facts have created concerns as discussed in the article, *Oil on ICE*:

> *"The phenomenal growth of ICE's West Texas Intermediate trading and the uncertainty over its market share have drawn the attention of lawmakers seeking to root out the cause of the oil spikes. The hazy information about OTC trading volumes has prompted critics to label ICE and other platforms 'dark markets,' susceptible to manipulation by anonymous investors. Lack of data about oil positions on ICE and other over-the-counter trading has prompted lawmakers to introduce roughly a half-dozen bills addressing 'speculation' in oil futures. One of the most vocal on Capitol Hill has been Sen. Maria Cantwell, D-Wash), chairman of the Commerce Committee's energy subcommittee. Legislation Cantwell has introduced with Sen. Olympia Snow, R-Maine, would give the CFTC more authority to regulate ICE operations for U.S.-delivered energy contracts. Their bill would essentially put ICE trading of West Texas Intermediate under the same CFTC regime as trades on Nymex. Currently, those ICE trades are overseen primarily by London's Financial Services Authority. Despite the presence of ICE*

*Futures' major trading desks in Atlanta and Chicago, CFTC rules allow overseas regulators to take the lead when they provide comparable regulation to the U.S. This exemption to U.S. oversight is referred to derisively by critics as the 'London loophole.' 'It is of critical importance we unmask who is playing in these dark markets,' Cantwell says."* [22]

The ***Oil on ICE*** article continues with comments from one of the more credible critics of the ICE Platform:

*"One of the most outspoken critics of ICE and the CFTC's seeming reluctance to fully oversee its operations in the U.S. is Michael Greenberger, a former CFTC official and now a law professor at University of Maryland School of Law. Greenberger, who worked at the CFTC from 1997 to 1999, was part of the team that drafted a regulatory response to the near collapse of hedge fund Long-Term Capital Management. Greenberger has been pressing Congress to close the "Enron loophole," which was created as part of the Commodity Futures Modernization Act of 2000 and allowed energy commodities trading on deregulated exchanges. The exemption, Greenberger says, led to Enron's subsequent market manipulation and the West Coast electricity crisis and may be permitting unobserved speculation today. He insists a recent attempt to close the loophole, by a provision in the recently enacted Farm Bill, is insufficient because it requires the CFTC to carry out a long hearing process for any contract it believes should be subject to agency oversight."* [23]

Other concerns are raised by a hedge fund manager:

*"But critics of ICE say the investment banks that helped found the exchange, particularly Goldman Sachs and* ***Morgan Stanley****, have used it to funnel institutional investors into commodities index funds to the detriment of producers who rely on the exchanges to set prices according to supply and demand for the physical product. 'These markets do not exist for the purpose of speculation,' says Michael Masters, managing member of hedge fund sponsor* ***Masters Capital Management LLC****. Because demand from institutional investors has driven the price of commodities beyond their actual demand, Masters says, 'many physical commodity market participants are now losing faith in the futures price as a benchmark for their transactions.'*

*Masters notes that 10 years ago, physical hedgers -- the farmers and producers looking to lock in prices on their deliveries -- accounted for 79% of the average long positions in commodities futures. The traditional speculators who acted as the necessary counterparties to hedging contracts accounted for 14%, and only 7% were index speculators. Today, however, the numbers have changed: He says index speculators comprise 40% of long open interest; physical hedgers about 34%; and hedging counterparties 26%."* [24]

The ***Oil on ICE*** article concludes with the following:

> *"In the end, both sides in the oil price debate agree on at least one thing: Until policymakers know who is trading and how much, the root cause of the crisis won't be uncovered."* [25]

The problem, however, is that the Intercontinental Exchange (ICE) does lack transparency, which raises reasonable concerns. It is precisely that lack of transparency that provided the opportunity for a possible Phase One run up in oil prices. As noted earlier, an oil price of $125 a barrel would produce something close to $2 trillion in a year after producing $1.2 trillion in 2007. Even with the year-end 2008 price drop, it is reasonable to assume that oil production (accounting for 61% of all SWF funding) added trillions to Sovereign Wealth Funds in just the past few years.

If the SWFs were acting to maximize economic results, it is only logical to believe that they would invest a portion of their excess revenues into hedge funds that positively speculate on increased oil prices. This would create a positive feedback loop that would be self-sustaining through a full cycle. Of course, at some point, higher prices would become unsustainable as they would sufficiently slow economic activity as economic growth depends on energy.

All of this analysis is reasonable and supportable. Under normal conditions, an economic actor would seek to maximize returns and would therefore slow any price rise to reduce suspicion and minimize negative impacts on demand. A desire to spike prices may imply other intentions more in line with the oil as a weapon theory.

In the ***CounterTerrorism*** Blog, this theory is discussed at length in an article ("*OPEC War against America's Economic Independence?"*) written by Walid Phares, professor of Middle East Studies at Florida Atlantic University, author of numerous books, FOX News analyst, and senior fellow at the Foundation for Defense of Democracies:

> *"According to economic analysis the severe financial crisis ravaging the US and hitting the international community on all continents has its economic roots in two major realms: One was the overbearing political pressure put on Wall Street to release loans into unprepared sectors of society and two, was the miscalculation - some say the drunkenness- of Wall Street in accepting these immense risks. But according to Political Economy assessment, there may have been a third player in the crisis: OPEC, or more precisely, radical circles within Oil Producing regimes in the Peninsula. The thesis argue that combined Salafist-Wahabi and Muslim Brotherhood circles in the Gulf -with consent from the Iranian side on this particular issue, used the escalating pricing of Oil over the past year to push the financial crisis in the US over the cliff. The 'high point' in this analysis is the timing between the skyrocketing of the prices at the pumps and the widening of the real estate crisis. In short the "Oil-push" put the market out of balance hitting back at Wall Street. Basically, there was certainly a crisis in mismanagement domestically (with its two above mentioned roots), but the*

> *possible OPEC economic 'offensive' crumbled the defenses of US economy in few months."* [26]

Dr. Phares continues in his analysis:

> *"OPEC's manipulation of the markets did hit Americans hard in their pockets. Hundreds of millions of John and Jane Does were intimidated, terrorized really, into abandoning their lifelong dreams of owning properties because of the aggressive stance of petro-regimes towards the US and its campaign to spread democracy in the Greater Middle East. In historical terms, America was punished for daring to change the status quo in the Arab and Muslim world to the advantage of the weakest and the suppressed: Shia and Kurds in Iraq, Syrian reformers, Lebanese civil society, Africans in Darfur, Iranian women and students, artists and liberals across the Arabian Peninsula. In return, the U.S was submitted to economic destabilization, steady, gradual and by small doses. Let's not underestimate the power of the Jihadi-oil lobby in America: it has decades of influence and it has long arms into the system, and it has powerful political allies. It knows when Americans are messing up their own system, and it knows very well how to push them over the cliff, into the abyss of economic calamity.*
>
> *A counterpoint to this thesis would vigorously argue that the alleged OPEC destabilization over the US economy is illogical, as many countries in the Gulf are experiencing a recession as a result of Wall Street's crunch. In other words, they wouldn't do it to themselves. Yet the ideological forces manning the oil weapon aren't particularly concerned about economic stability. Their driving factor is Jihadism. We've heard their ideologues stating that even if they were to incur losses among their own societies in order to defeat the infidel powers, then let it be."* [27]

Perhaps the most powerful portion of Phares' argument can be found in the direct quotes from Jihadists.

> *"Sheikh Yussuf al Qardawi, Muslim Brotherhood ideologue and mentor of the Qatari-funded channel, spoke openly of Silah al Naft, i.e, 'the weapon of oil.' Indeed, it was called a weapon - as in a warfare situation -- and most likely it was used as such. Of course, the producing 'regimes' will deny the existence of a real strategy to bring the US to its knees by striking at its pumps. They will dismiss statements made by emirs and commentators in this regard. The 'field Jihadists,' however, won't deny the existence of such a battlefield.*
>
> *For years now, Salafist web sites and al Qaeda spokespersons have loudly called for an 'oil Jihad against infidel America and its lackeys.' Online material is still circulating. But more revealing are the official speeches by Osama Bin Laden and his deputy on the 'absolute necessity to use that weapon.'"* [28]

Due to the lack of transparency in trading at the Sovereign Wealth Fund, Hedge Fund, and trading exchange levels (as will be discussed at length later in this paper), it may be impossible to produce forensic evidence to prove that a Phase One attack on our economic system took place. What can be demonstrated beyond reasonable doubt is that oil speculation took place and Sovereign Wealth Funds acting through Hedge Funds are among the likely suspects. Beyond that (as will be described later in greater detail), the SWFs have become increasingly connected with the Shariah movement.

According to the theory, the purpose would be to generate excess capital that would be used in a Phase Two effort. This remains a theory, albeit a plausible one. It is also possible that the speculation was purely economic in nature. It should be noted that most commodities increased in price at the same time, perhaps from demand or speculation.

## Phase Two: Bear Raids on the Markets

It is necessary first to grasp the basic Wall Street concept that some market participants desire to see the price of a certain stock or even the market as a whole decline. Traditionally, the motive has been profit and the mechanism has been described as a "bear raid." The concept of a "bear raid" is fairly simple. Former hedge-fund manager Andy Kessler, in an Op-Ed (26 March 2009, *Wall Street Journal*) described the basic form:

> *"In a typical bear raid, traders short a target stock – i.e., borrow shares and then sell them, hoping to cover or replace them at a cheaper price. Once short, traders then spread bad news, amplify it, and even make it up if they have to, to get a stock to drop so they can cover their short."* [29]

Traditionally, short selling is a technique wherein an investor or speculator borrow shares of a particular stock or market index (a stock loan) and then offers the shares for sale with the intention of buying them back (known as "covering") at a lower price at some point in the future (thus repaying the stock loan). This form of short selling is legal, legitimate, and even positive for overall market efficiency. In fact, short sales represent future buying of shares. Short sellers profit if the stock drops in price but experience losses if the price rises.

The difference between basic short selling and a bear raid is in the manner and nature of the short selling. Bear raids involve some sort of manipulation through rumors or other violation of market rules.

The bear raid has a long history on Wall Street. Edwin LeFever's classic, *Reminiscences of a Stock Operator* was first published in 1923. It is widely believed to be the biography of stock market whiz Jesse Livermore and explains in detail how bear raids operate. Many experts attributed the crash and the corresponding depression to a series of bear raids conducted by Livermore and others that took place in 1929. Legend has it that Livermore profited by more than $100 million from the Wall Street crash.

The concern of market manipulation was so great in the 1930s that it provided the genesis for the creation of the Securities Exchange Commission and the appointment of its first chairman, Joseph Kennedy. Almost immediately, the Commission undertook a variety of efforts to curb bear raids including instituting the "uptick rule" and other methods to reduce manipulation. [The uptick rule will be discussed in greater detail later in this report.]

During calmer market periods, academicians have sometimes attempted to deny the existence of successful bear raids. They argued that ultimately the market will fairly price securities based on the efficient market hypothesis. In this view, any bear raid could at best be temporary, as buyers would step in to purchase any undervalued stocks. This, however, ignores the reality of market panic, wherein investors act irrationally. It also stands against the fact that virtually all market participants acknowledge the reality of bear raids.

A recent Op-Ed by George Soros was titled *"One Way to Stop Bear Raids."* Soros is no stranger to the markets, having managed billions of dollars globally for several decades through his Quantum (hedge) Fund. He also has been accused of conducting bear raids against the Bank of England (among others) and in 2002 was convicted in French court of insider trading, even though he denied the allegations.[30]

Soros acknowledges the reality of bear raids and refutes the primary academic argument against them:

> *"Up until the crash of 2008, the prevailing (academic) view – called the efficient market – was that the prices of financial instruments accurately reflect all the available information (i.e. the underlying reality). But this is not true."* [31]

Even the academic world recently has come to recognize that bear raids do in fact take place. The April 16, 2008 issue of *Knowledge@Wharton* was titled *"'Bear Raid' Stock Manipulation How and When It Works, and Who Benefits."*

The main point of the Wharton article:

> *"No one openly admits to conducting a 'bear raid,' since deliberately manipulating stock prices is illegal. But, Wall Street has long believed bear raids can and do take place. There has, however, been little academic research to explain the forces at work. Now, two finance experts have shed some light on the process. 'We basically describe a theory of how bear raid manipulation works,' says Wharton finance professor Itay Goldstein. He and Alexander Guembel of…the University of Oxford describe the procedure in their paper titled,* 'Manipulation and the Allocation Role of Prices.'
>
> *Their key finding illuminates the interplay between a firm's real economic value and its stock price, showing how traders who deliberately drive the share price*

> *down can undermine the firm's health, causing the share price to fall further in a vicious cycle."* [32]

Of course, even the prior arguments against the existence of bear raids were predicated on the concept that investors would tend to act in what they believed to be their own economic interests. As this report shall discuss, actions undertaken for non-economic reasons (wherein profit was not the primary motive) would further support the case for bear raids.

Thus, Wall Street History from the 1920s, major market participants along with the most recent academic theory all support the reality that it is possible to target specific companies or industries with bear raids -- deliberate downward manipulation of prices. The purpose and intent can be simple profit, the demise of the company or industry, or something even more sinister.

Returning briefly to the Bear Stearns collapse, the words of SEC Chairman Christopher Cox in his 20 March letter to Dr. Nout Wellink, Chairman of the Basel Committee on Banking Supervision, are particularly illustrative. Cox stated:

> *"…the fate of Bear Stearns was the result of a lack of confidence, not lack of capital…Beginning late Monday, March 10, and increasingly through the week, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. Notwithstanding that Bear Stearns continued to have high quality collateral to provide as security for borrowings…"* [33]

The basic conclusion of many market observers is that Bear Stearns was the target of a very successful bear raid. Despite this, due in large part to a Fed-orchestrated rescue via acquisition by JP Morgan, the bear raid was contained and the overall stock market recovered. In fact, the S&P 500 Index actually rose more than 10% in the two months following Bear Stearn's demise. Unfortunately, the impact of a bear raid on Lehman had a different outcome for the company, the market, and the overall economy.

## Modern Bear Raids

The reality of bear raids is beyond reasonable dispute. Yet, this is only the tip of the iceberg. Substantially more sophisticated and efficient versions have been developed in the past few years. These modern weapons of financial destruction rely on complex derivative strategies that operate well ahead of the regulatory framework. In addition, they exploit loopholes and regulatory lapses.

As with the basic bear raid, the existence of the more sophisticated versions is also a reality beyond reasonable dispute. These involve the use of Credit Default Swaps, naked shorting, Exchange Traded Funds (ETFs), and option strategies. In addition to providing increased effectiveness in bringing down individual stocks and the market, these more sophisticated versions are also more difficult to trace.

The modern bear raid was seemingly successful in bringing down Bear Stearns in March of 2008. The encore perpetrated against Lehman in September 2008, was far more successful, bankrupting the long-standing firm, crashing the stock market, freezing the credit markets, and throwing the global economy into near depression. A 19 March 2009 Bloomberg report suggested the following:

> *"The biggest bankruptcy in history might have been avoided if Wall Street had been prevented from practicing one of its darkest arts."* [34]

As with Bear Stearns, the move against Lehman Brothers was a full bear raid using naked short selling, rumor spreading, and the manipulation of credit default swaps. According to the Bloomberg report, 23% of the trading in Lehman Brothers on 17 September 2008 was failed trades suggestive of naked short selling (which is discussed later in this paper). This came after two summer rumors regarding Lehman Brothers that were proven false but nonetheless damaged Lehman's business. In both cases, naked short selling spiked as the rumors circulated. On 27 June, naked shorting jumped 23-fold. The next trading day, 30 June, a rumor circulated that Barclays would buy Lehman at a price 25% below the then market price. The damage was done and the stock fell 11% despite adamant denials by both Lehman and Barclays. Over the next six trading days, the number of failed-to-deliver trades (indicative of naked short sales) occurred at a rate 46 times greater than the level of 26 June. Then on 10 July, another rumor was spread that two significant clients had stopped trading with the firm. Despite complete denial by all parties, Lehman's stock dropped an additional 27%.

**False rumors and naked short selling continued in Lehman stock until the bank finally failed in mid-September. By then, the amount of failed-to-deliver trades was more than 1,600 times greater than the amount just three months earlier.** The stock had fallen to near zero. As with Bear, Lehman collapsed despite having sufficient capital to meet all requirements until just before the end. The constant rumors, combined with the stock decline hampered the firm's ability to raise capital or conduct business. Without the rumors, Lehman would likely have been in a position to continuing operating or at least find a business partner and retain some level of shareholder value. This, in turn would have likely prevented the need for the TARP bailout and avoided much of the market and economic dislocation that took place.

The reality is that a very modern form of bear raid was perpetrated against both Bear Stearns and Lehman Brothers. In the case of the former, government intervention reduced the overall impact. In the case of Lehman, however, the firm was allowed to collapse and that triggered economic chaos.

The real questions are WHO began the attacks, HOW were they accomplished, and WHY? These questions are addressed in this report.

## The Emergence of Credit Default Swaps

There should be no question that Credit Default Swaps (CDS) played an integral role in the 2008 collapse. The fact that the CDS market reached $62 trillion in notional value at the end of 2007 (nearly five times U.S. annual GDP) according to the ISDA (International Swaps and Derivative Association, www.isda.org), up from less than $1 trillion in 2001, demonstrates how important these formerly obscure instruments have become relative to the overall economy. Despite the huge marketplace for CDS however, a lack of transparency and regulation led to a situation that made the overall system very vulnerable to manipulation.

Credit Default Swaps are derivative instruments of the type that Warren Buffett once described (Berkshire Hathaway 2002 Letter to Shareholders) as "financial weapons of mass destruction carrying dangers that, while now latent, are potentially lethal." [35] This was certainly the case in 2008.

Despite their significance to the marketplace, the CDS market was "regulated by no one" according to SEC Chairman Christopher Cox's September 23, 2008 testimony before the United States Senate. Cox also testified that *"Neither the SEC nor any regulator has authority over the CDS market, even to require minimal disclosure to the market."* This is tantamount to saying that this enormous market, nearly five times the size of total U.S. Gross Domestic Product, was completely unmonitored. Not only did regulators lack the ability to reign in the market but they also lacked the visibility. This is why Cox concluded that *"the (CDS) market is ripe for fraud and manipulation."* [36]

What makes Credit Default Swaps so significant is that they have the power to determine the financial viability of companies. This is true for virtually any company regardless of size. For example, General Electric's CEO Jeff Immelt once commented that *"by spending $25 million bucks in a handful of transactions in an unregulated market"* traders in credit default swaps could tank major companies. *"I just don't think we should treat credit default swaps as like the Delphic Oracle of any kind…it's the most easily manipulated and broadly manipulated market that there is."*[37]

In order to understand how the CDS market could be used to manipulate other financial markets, it is essential to understand the definition, origin, intended use, and actual use of credit default swaps. This information is contained in Appendix A.

Basically, what this suggests is that credit default swaps are ideal bear-raid tools, global in scope, unregulated, untraceable, and able to destroy companies simply by bidding up their price. The only aspect subject to debate is to what degree swaps were used to manipulate the markets. The fact that they could have been manipulated is beyond dispute. The good news is that there has been some effort to address the potential for manipulation. Unfortunately, there are other tools that combined with credit default swaps that make bear raids even more lethal.

## Naked Short Selling

According to the SEC, a short sale is the sale of a security that a seller does not own (or that the seller owns but does not deliver). In order to deliver the security to the purchaser, the short seller will borrow the security, typically from a broker-dealer or an institutional investor. The seller would then hope for the price to decline so that at some point in the future he or she would be able to repurchase the shares at a lower price, pocket the difference between the purchase and sale price as a profit, and then return the borrowed shares. In general, all of this is legal and most academicians believe beneficial to the markets over the long term by adding liquidity. The key is that the shares must be legally borrowed and at some point properly returned by repurchasing them on the open market, known as “covering the short.”

It is important to note that stock prices are essentially set “at the margin.” This means that the last trade, regardless of the volume sets the price for the stock. As a result, a small number of trades at the margin have the potential to radically define the value of a company and ultimately the overall market and economy. This is an essential concept to grasp. What it means is that a concerted effort to adjust prices is possible even if only a fraction of the outstanding shares are actually traded.

Naked short selling occurs when shares are sold without first owning them or borrowing them. This practice is basically illegal with a few exceptions created to promote short-term liquidity. Unfortunately, provisions against naked short selling have had lax enforcement by regulatory authorities in recent years, creating a serious vulnerability in our financial markets.

John Finnerty, Professor of Finance at Fordham University published a significant study in March 2005 titled *Short Selling, Death Spiral Convertibles, and the Profitability of Stock Manipulation.* Among his conclusions is the following:

> *“Naked short selling can increase the manipulator’s profit. A short seller, who profits by buying the shares to cover her short position at lower prices than the selling prices, can drive the price of a stock lower by selling short a larger number of shares. Without enforceable restrictions requiring short sellers to borrow the shares before they can commit to sell, a short seller might destabilize the market for a particular stock through naked shorting. While some naked shorting may take place for benign reasons, for example because it lowers the cost of short selling (Geezy, Musto, and Reed, 2003), Regulation SHO reflects the SEC’s concern that previous restrictions on short selling had not been effective in preventing its use as a manipulative device (SEC, 2003b, 2004). There is mounting evidence that manipulative short selling has seriously disrupted the market for some over-the counter stocks.”* [38]

Finnerty offers a compelling theoretical and empirical case to support his conclusions. In the simplest terms, however, those who sell shares that do not exist (the definition of naked short selling) are essentially counterfeiting shares. They are artificially driving up the supply of stock. At the same time, their actions are simultaneously dampening demand for the same shares by raising the short interest on the company. Quoting Finnerty:

> *"Aggressive short selling is a bearish signal. Desai et al. (2002) find that a high level of short interest sends a strong negative signal because heavily shorted stocks experience significant negative abnormal returns during the period they are heavily shorted and have a higher probability of delisting relative to the size and industry-matched control firms. Naked shorting intensifies those effects."* [39]

Put quite simply, naked short selling diminishes buyer interest and results in lower demand for a stock. The only rational conclusion is that anything that increases supply and reduces demand will by its own actions cause prices to fall. As a result, naked short selling, albeit illegal, has the ability to manipulate prices for stocks lower and thus produce substantial profits.

Another very serious problem, beyond affecting the supply/demand of a stock has to do with investor confidence. Just as with high credit default swap premiums, a large short position can reduce a company's ability to raise capital. In the case of high CDS rates, a company can find it difficult if not impossible to borrow money. With a larger circulation of stock than issued, a company can find it difficult if not impossible to float a secondary stock offering. Thus, with constrained capital opportunities, the company's growth is likewise constrained at a minimum. In a worst-case, the lack of capital can prove fatal to the company.

Constrained capital access for systemic institutions such as Bear Stearns or Lehman Brothers was a threat to the entire system. With sufficient capital, and no restriction on availability of shares to short, it is theoretically possible to target and attack key companies and industries. The fact that there were nearly 33 million shares of Lehman Brothers sold and not delivered to buyers on time (a 57-fold increase over the peak in the prior year), in the context of the global financial meltdown, cannot be overlooked.

The across the board decline of share prices combined with rapidly rising CDS rates creates a disequilibrium in markets and thereby negates the arguments that naked shorting has little or no impact. If credit markets freeze and investors panic, new naked short positions such as those established in Lehman Brothers in mid 2008 do have an impact. There were 33 million undelivered shares of Lehman at the time of its collapse, part of an equation that caused Lehman's stock price to fall from the mid $60 range to near zero in short order. [40]

The inability to raise capital forced Lehman into bankruptcy. Yet the naked short position was so large that nearly nine months later, the stock was still trading at $0.05/share. This trading is necessary for the large number of short sellers to cover their position and free up their remaining capital.

**Dr. Susan Trimbath estimated that failed trades from naked short sales could account for 30-70% of the decline in share values for Bear Stearns and Lehman.** [41]

That is an amazing statistic. If accurate, it suggests that a restraint on naked short sales might well have averted Lehman's bankruptcy. Given time and their capital position, Lehman would have likely found a mechanism for survival. The net cost to the overall financial system, including rescue packages, might have been substantially less than experienced.

As an aside, defenders of short selling often attempt to justify the Lehman collapse based on a financial condition so poor that there were no willing buyers. Like many other pro-short arguments, this one is suspect as well. The fact that there were no willing buyers in the midst of the greatest capital crunch of modern times should not be surprising. The Lehman collapse did not occur in a vacuum and many potential buyers were assessing their own viability. A Korean buyer actually walked away from the deal based on market activity in Lehman stock as well as the high cost to insure its debt through CDS. In hindsight, there was unrecognized value in the firm as evidenced by Barclay's recognizing nearly $4 billion of gains on former Lehman assets just three months after the Lehman bankruptcy. Clearly there was value in the firm; it is just that few were willing to look for it given the cloud of uncertainty.

It is clear that a comprehensive approach to curbing manipulative short selling is needed. Reforms should include a possible reinstatement of the uptick rule, requiring delivery for every short sale (thus outright banning naked shorting), requiring disclosure of all outstanding short positions, and limitations on market maker exemptions. In addition, penalties for violations should be clear, specific, enforceable, and strong. This would be in sharp contrast to recent SEC non-actions such as virtually ignoring 5,000 complaints of manipulative naked short selling. Even when action has been taken, it is often well after the fact. A case in point is the May 2009 announcement of a civil action (concerning insider trading with credit default swaps) regarding alleged illegal activity that took place in July 2006.[42] While it may be acceptable from a legal standpoint to enforce insider trading laws three years after a violation, such delays render any action against bear raids virtually useless.

It should be noted that the SEC is currently considering wholesale reforms of its short selling rules. Hopefully the serious weaknesses that have been exploited will be addressed. Regardless, without effective enforcement provisions, any new rules will prove ineffective.

[For a more complete description of naked short selling, a lack of enforcement according to the SEC's Inspector General, additional risks to the system, and a loophole provided to market makers known as "the Madoff Exemption," please refer to Appendix B.]

## The Uptick Rule

Many experts believe that the situation also has been complicated by the rescission of the long-standing “uptick rule” limit on short selling. The uptick rule was put in place in 1938 precisely to stop the bear raids that many experts believe led to the 1929 crash as well as the 1937 collapse.[43] These bear raids seriously eroded public confidence and hampered an economic recovery that began in 1932. The stock market actually regained about two-thirds of the losses from the crash through 1936. Following that, however, a new collapse erased about half of the market’s value. It was at that point that the uptick rule was put in lace to prevent further bear raids from stifling any recovery. The major market averages never again broke below those lows.

The uptick rule required that a stock could only be sold short following a trade at an uptick (where the trade was at a higher price than the trade before it). What this did was limit a short seller’s ability to drive down a stock price simply from continual selling. In essence, it gave the market a time to pause and breathe, so to speak. This rule stood in place from 1938 until July 3, 2007 when it was rescinded. Coincidently, this rescission occurred very close to the market peak in 2007 just as the adoption of the rule occurred close to the market’s bottom in 1938. Short selling spiked in August 2007.

[A more complete description of the uptick rule and the debate surrounding it is provided in Appendix C.]

## Double and Triple-Short ETFs

The rapid growth of Short, Double-Short, and even Triple-Short (leveraged) ETFs has no doubt added to short selling by making it much simpler for investors. Many observers believe that this would not have been possible without the market maker exemptions for naked shorting and the elimination of the uptick rule. At a minimum, the advent of these products exacerbated short selling trends in a down market. To the degree that these instruments increased naked short selling (which is quite likely), they added to artificial selling volume as previously discussed.

There is little doubt that ETFs have contributed to the volatility in the last hour of the trading day, at least at the margin. ETFs square their books during the last hour of trading, often dumping huge block orders on the market. Overall, recent estimates are that approximately 40% of New York Stock Exchange volume is from ETFs.[44]

An article in the Wall Street Journal (*Are ETFs Driving Late-Day Turns*) by Tom Lauricella, Susan Pulliam, and Diya Gullapalli documents that *“On eight of the 10 worst days for the S&P 500 since Sept. 1, 29% or more of the move took place in the final hour; on three days, more than half the selloff occurred after 3 p.m.”* The article goes on to state that *“On many days, leveraged ETFs are now some of the most actively traded securities in the stock market.”*[45]

Perhaps in isolation, the impact of short ETFs and even UltraShort ETFs might have had a minimal market impact. In combination with naked short selling and the elimination of the uptick rule, however, they certainly measurably added to the selling pressure. The fact that the confluence of these market moving forces matches with the stock market's peak in mid 2007 creates serious questions about whether the supposed benefits of these instruments outweigh the risks they create.

[Additional background on double-Short ETFs can be found in Appendix D.]

Overall, short selling (including naked shorting and double-short ETFs) aided by the elimination of the uptick rule, clearly played a part in the bear raids of 2008. It should be noted that the SEC briefly instituted a ban on short selling following the Lehman collapse. At this point, however, the damage already may have been done as panic was underway.

[A brief analysis of the SEC ban is included as Appendix E.]

## How Bear Raids Froze the Capital Markets and Harmed the Economy

There should be little doubt that a series of bear raids using advanced techniques were perpetrated against key U.S. financial services companies. This can be seen in the nature of the initial attacks against Bear Stearns and Lehman Brothers, the reaction of the Treasury Department, SEC, and Federal Reserve at the time, and the after action reports from investors such as George Soros. Likewise, noted experts such as former SEC Chairmen Harvey Pitt and Christopher Cox have provided comments that directly lead to the conclusion that bear raids did, in fact, take place. The only possible debate on the subject must be limited to factors such as the specific mechanism of the attacks (CDS, naked short sales, rumors, all discussed in greater detail in the Appendices), the impact of the bear raids (did they trigger the economy or vice versa), and who was behind the attacks. The evidence is very clear that bear raids did, in fact, happen.

In terms of the economy, the collapse of Lehman Brothers clearly caused an immediate credit market freeze and stock market collapse. This was in contrast to the events following Bear Stearns collapse a few months earlier. In that instance, the stock markets recovered and credit markets normalized. The economy appeared to be in a minor recession. Lehman's collapse, however, began a chain reaction of credit problems that were in no way isolated, leading to what many observers believed would be the second Great Depression.

It is important to note that the viewpoint that Lehman's failure was a, if not the, key trigger to the economic implosion is nearly universal. It was widely held immediately after the failure and remains the dominant view eight months later as this report is written. This view has been supported by both public and private economists, in the United States and abroad. Even those who might want to debate the conventional wisdom typically argue relatively minor distinctions. For example, Stanford economist John Taylor wrote a paper making the case that the Lehman failure was not the problem. Even then, his conclusion is that the crisis was really the product of market uncertainty about the effects of government action at the time.[46] It really doesn't matter if the trigger was the failure or the uncertainty created in the wake of the failure. Either way, a bear raid on Lehman caused both the failure and the uncertainty and thus set off the crisis dominoes.

Noted economist Paul Krugman, Ph.D. (Professor of Economics and International Affairs at Princeton) commented that *"The collapse of Lehman Brothers almost destroyed the world financial system."*[47] James Surowiecki called the Lehman failure *"the first, and crucial, moment in last fall's market panic…in this case, then, the conventional wisdom seems to be right."*[48] French Economy Minister Christine Lagarde said that Lehman's failure threatened *"the equilibrium of the world financial system."* The consensus view among global finance ministers was summed up in the headline of a 13 October 2008 Insurance Journal article: *"The Lehman Failure Seen as Straw that Broke the Credit Market."* [49]

In hindsight, on 16 April, Federal Reserve Bank of San Francisco President Janet Yellen called the impact of Lehman's failure *"devastating"* and said *"That's when this crisis took a quantum leap in terms of seriousness."*[50]

A 29 September 2008 article in *The Wall Street Journal* provided a contemporaneous view of the events that unfolded immediately after Lehman failed. The story, titled *Lehman's Demise Triggered Cash Crunch Around Globe*, described the failure a *"a turning point in Crisis."*[51]

According to this article, the chain reaction of destruction included:

- the downward spiral of AIG,
- chaos at Morgan Stanley and Goldman Sachs,
- immediate losses of nearly $1 billion at Norway's government pension fund,
- more than $140 billion of margin calls for firms which sold credit default swaps,
- a rushed $700 billion bailout plan (TARP),
- billions of uncollectable debts for hedge funds and banks where Lehman was the counterparty,
- mass rumors about nearly every other financial institution,
- the sharpest spike ever in the history of LIBOR (from under 1% before the failure to 6.44%),
- a complete collapse of interbank lending despite the higher rates,
- a plunge in the overall market in general and the stocks of financial companies in particular, and
- "a breaking of the buck" at the Reserve Primary Fund (that held Lehman debt), the first time a money fund fell below $1 a share in 14 years.[52]

This was just a small portion of the chaos at work that nearly destroyed the global financial system in a matter of days. Over a two-month period from mid-September to mid-November, the S&P 500 dropped almost 40%, a decline matched only with the market crashes of 1929 and 1987.

The only real winners of such chaos were those who were net short financial stocks or the market in general. That's because the quoted value of nearly every asset declined due to a process known as deleveraging. Basically, to meet margin calls caused by Lehman's demise, investors were selling anything that might bring cash. There was a massive "flight to quality" that moved enormous amounts of money into U.S. Treasury instruments. In fact, so much money moved that direction that investors actually paid the government to hold their money for them. This created a negative interest rate for a brief period, a very rare event.

George Soros provided perhaps the most concise commentary in a 30 April 2009 symposium sponsored by the New York Review of Books with his opening remarks:

> *"…the financial system as we known it actually collapsed. After the bankruptcy of Lehman Brothers on September 15, the financial system really ceased to function. It had to be put on artificial life support. At the same time, the financial shock had a tremendous effect on the real economy, and the real economy went into a free fall, and that was global."*[53]

It is necessary to recall the Soros authored Op-Ed in the Wall Street Journal, (*One Way to Stop Bear Raids).* [54]

His bottom-line conclusion was:

> ***"…it's clear that AIG, Bear Stearns, Lehman Brothers and others were destroyed by bear raids in which the shorting of stocks and buying CDS mutually amplified and reinforced each other. The unlimited shorting of stocks was made possible by the abolition of the uptick rule, which would have hindered bear raids by allowing short selling only when prices were rising. The unlimited shorting of bonds was facilitated by the CDS market. The two made a lethal combination."***[55]

The inevitable conclusion is that Lehman's failure was the primary trigger that began the massive credit freeze and near-depression collapse of the economy. In turn, it is obvious that Lehman's demise was the direct result of a series of bear raids perpetrated against major financial companies. The bear raids were made possible by the unregulated rise of credit default swaps, unlimited naked short selling, the elimination of the uptick rule, and the creation of leveraged ETFs.

# The Perpetrators

Upon reaching the rational conclusion that bear raids did take place and that these directly triggered the economic turmoil, the next logical question become, “Who Did It?” Unfortunately, this is a much more difficult question to answer with conclusiveness. The reason is that there has been a serious lack of transparency in regard to the primary instruments used in bear raids, notably credit default swaps and naked short sales. Complicating the matter further is the fact that those who initiate the trades are typically hidden behind brokerage firms, hedge funds, foundations, and other client pools. A third layer of complexity is caused by globalized securities markets wherein trades can be placed in one geography for instruments in a different country to be transacted in a third location.

An illustration of this problem can be seen in the difficulty of constructing a simple client list of fraud victims from Bernie Madoff’s alleged Ponzi scheme. The official list, released to the public in February rambled for 162 pages with some 13,500 entries, many of which were duplicated numerous times.[56] In addition, all parties agree that the list is nowhere near complete and some question its accuracy. Yet, this is the official court document compiled at great expense and effort by AlixPartners LLP of Dallas.[57] At first thought, it would seem that making a list of clients might be fairly straight forward, especially since Madoff produced regular and ongoing client statements with names and addresses. The complication, however, is that among the Madoff clients were hedge funds, funds of funds, offshore funds, and numerous other layers of intermediaries between the assets and the clients. And these complications exist in a case where the clients desire to be identified so that they may benefit from any asset recovery. The situation would be obviously more difficult if the end clients preferred to stay hidden.

Regardless of the motive, the actors behind the bear raids not only prefer anonymity but most likely planned for it from the beginning. This suggests layer upon layer of secrecy through foreign shell corporations, feeder funds, and numerous other pass-through entities. Historically, hedge funds have disclosed nothing to the government and very little to the public. Even from a tax standpoint, there has been virtually no ability for governments to track investment results back to most clients.

> *“Hedge funds are now responsible for over half the daily trading in the equity markets, due to their huge size and the huge amounts of capital funding them. That gives them an enormous amount of control over what the markets will do. In the fall of 2006, 8,282 of the 9,800 hedge funds operating worldwide were registered in the Cayman Islands, a British Overseas Territory with a population of 57,000 people. The Cayman Island Monetary Authority gives each hedge fund at registration a 100-year exemption from any taxes, shelters the fund’s activities behind a wall of official secrecy, allows the fund to self-regulate, and prevents other nations from regulating the funds.”*[58]

The IRS has had virtually no success in identifying even U.S. citizens who hold hedge fund investments, let alone foreign entities. In fact, tax laws do not even require feeder funds to collect information on their clients. The lack of transparency makes hedge funds extremely attractive to those who desire anonymity.

A 19 June 2006 Business Week article opened with the following:

> *"When drug runners and terrorists want to park illicit cash, there may be no better haven than hedge funds. Despite tough new anti-money laundering standards put out by U.S. regulators for banks, mutual fund companies, insurers, and money transmitters, the highly secretive hedge fund industry has no restrictions whatsoever. Says Peter Djinis, an attorney and former executive assistant director for regulatory policy at the Treasury Dept.'s Financial Crimes Enforcement Network (FinCEN): 'The lack of controls is conspicuous.'*
>
> *And perhaps dangerous. For more than three years, the Securities & Exchange Commission and the Treasury Dept. have been discussing how to include hedge funds in the USA Patriot Act, the 2001 legislation designed to protect against terrorism. Yet during that time, the $1.3 trillion hedge fund industry has collected record amounts of cash, some of which could well be from questionable sources. Intermediaries who introduce hedge funds to investors often don't divulge clients' names, and funds rarely ask. 'This is a very opaque industry,' says Jeff Brenner of Intelysis Corp., a corporate intelligence firm with offices in Cherry Hill, N.J. 'There's no indication of who is behind these accounts.'* ***As it stands, hedge funds have no responsibility to determine the sources of investor funds or to analyze whether they're questionable."***[59]

Amazingly, three years later and the secrecy cloak for hedge funds remains intact. In fact, Senator Carl Levin recently complained that the (Bush) *"Administration's five-year failure to extend anti-money laundering controls to hedge funds with offshore money…is inexplicable, ill-timed, and unwise."* Levin went on to say that *"A 2006 investigation by my Subcommittee showed how hedge funds can bring suspect offshore funds into the United States…"*[60]

Complicating the matter further is the fact that even if it were possible to identify who had invested in the hedge funds, it still would be extremely difficult to determine where those hedge funds were invested. This is the second layer of secrecy and is staunchly defended by the funds themselves and even by the SEC as proprietary trading strategies. Despite a Transparency Act proposed by Senators Chuck Grassley and Carl Levin, there appears to be limited appetite to force hedge funds to disclose either their trading activity or their customers.

In regard to credit default swaps, the nature of the contracts was such that few, if any fingerprints were ever left. These were unregistered, unregulated private agreements where the parties virtually disappear as a swap gets traded 15 or 20 times. As a result, not even the hedged party knows who's responsible as counterparty or if they have the resources to make up the default.[61]

In terms of naked shorts, the SEC itself has led the effort to prevent disclosure. Their argument has been that such disclosure might arm investors with knowledge to perpetrate a "short squeeze" that would drive up prices for a stock artificially. Unfortunately, this lack of public disclosure complicates efforts to track down any bear raid perpetrators. Even when FOIA (Freedom of Information Act) information is obtained, it is available far too late to provide proper action (as evidenced in the Global Links case).

Transparency is further obscured by recent trends toward hidden orders, dark pools, and sponsored access. Each of these mechanisms has skyrocketed in popularity in recent years. Each has also made it increasingly difficult to track down the "who, what, and when" of trading.

On 29 January 2007, *Advanced Trading* published an article by Dan Mathisson, Managing Director and Head of Advanced Execution Services at Credit Suisse in New York that was titled *"Hidden Orders and Dark Pools are Taking Secrecy on Wall Street to a New Level."* As a head of trading for a major Wall Street firm, Mathisson is clearly favorable with regard to the secrecy, based on the idea that it brings more efficient execution of trades. His article makes the point:

> *"There is a strange phenomenon occurring in the U.S. stock markets: No one knows what's going on anymore, and the markets are better for it."*[62]

Assuming that all traders act in a law-abiding fashion and all intentions are honorable, this is likely a true statement. But in a world of bear raids and systemic risk, such secrecy is quite concerning. What it means is that huge orders can be hidden from traditional public view.

Anuj Gangahar expressed concerns regarding dark pool trading in a 5 July 2008 *Financial Times* article titled, "Is it time to shine some light into these dark pools?"

Like Mathisson, Gangahar agrees that dark pools take Wall Street secrecy to new heights:

> *"If something happens in the dark, its full impact can be difficult to assess until the lights come on. This notion is at the heart of concerns on Wall Street about how much equity trading is now taking place on internal crossing networks, or as they have been more mysteriously termed, dark pools.*
>
> *Dark pools are private interbank or intrabank platforms that are widely used to trade stocks away from exchanges. They are used by clients such as hedge funds to buy and sell large blocks of shares in anonymity…. According to consultancy The Tabb Group, dark pools already account for 12 per cent of US daily stock trading volume and this is rising."*[63]

*Investor's Business Daily* also published an article in which even Wall Street professionals expressed concern:

> *"But dark pools' secrecy is a problem, says Ralph Acampora, the New York Institute of Finance's director of technical analysis studies. 'There's an ability to hide; people should be concerned about it," he said. "You don't know where the (market) forces are coming from. In the past, you could identify it. Now it's a netherworld.'"*[64]

There are some 40 active dark pools in operation. Each provides anonymity to their clients and hides activity. In some cases, one dark pool may even trade through another, further obscuring what is actually taking place. As of now, there is no real oversight or regulation. Any reporting is after the fact and ad-hoc. James Brigagliano, co-acting director of the SEC's Division of Trading and Markets was quoted in May 2009:

> *"I'd like to give specific statistics on the trading volume, but there's very little reliable public information on dark-pool trading activity."*[65]

The bottom line is that no one, not even the SEC has access to accurate data on what happens in the dark pools. But, there is little doubt that what happens in the dark pools impacts normal exchange trading in major ways.

Another mechanism to access the markets while remaining hidden is called "Sponsored Access." According to an April 2009 article by Nina Mehta in Traders Magazine:

> *"The practice now under the lens is called "sponsored access." This mundane-sounding term refers to arrangements by broker-dealers that enable select market participants to fire off orders directly to exchanges . . . without passing through the broker's infrastructure."*[66]

Only registered broker dealers have direct access to the major trading exchanges. Granting "sponsored access" allows them to pass along this privilege to hedge funds and large clients. This leaves the responsibility for monitoring the trades to the sponsoring broker. The level of monitoring and compliance, however, varies greatly from one firm to another. This leads hedge funds to seek out the most lenient brokers.

According to James Leman, head of capital markets at Westwater Corp., a New York-based advisory and consulting firm that often works with broker-dealers: *"All brokers need to oversee their customers and apply [that oversight] evenly, or there will be double standards that allow hedge funds or others to seek out the most lenient broker. That could expose the market to potential manipulation or operational exposure."* Leman also notes that *"In some instances, hedge funds and prop trading firms would like to pick and choose the requirements they abide by, and ignore others that they don't think are important,"*[67]

> *"Nasdaq told Traders Magazine in February that about 15 percent of its executed volume comes through non-DMA sponsored access arrangements. Jeff Bell, an executive vice president at Wedbush Morgan Securities, which has a large sponsored access business, estimates that the market's overall non-DMA sponsored access volume is probably the same."*[68]

The concern, outlined by the Securities Industry and Financial Markets Association (SIFMA) suggests *"a potential 'disaster scenario' would be one (or multiple) Sponsoring Members allowing almost unencumbered trading activity and market access, thereby accumulating significant counterparty exposures to the sponsoring exchanges well in excess of their risk capacity. Under such a scenario, were a significant amount of these trades to fail, the sponsoring exchanges and, by extension, the overall market, may be left with significant financial exposures that could adversely impact all trading activity in the market."*[69] It is worth noting that SIFMA is in favor of continuing sponsored access, suggesting that these are very valid concerns to consider.

The National Association of Securities Dealers is worried "that bad or problematic orders that aren't properly monitored could cause disruptions in the market." And has thus proposed rules to regulate how orders get placed to the market via sponsored access. Likewise, James Brigagliano of the SEC echoed the concerns recently, noting that a variety of risks exist when trading firms have unfiltered access to the markets:

> *"These risks can affect many participants in the market structure, including the trader's broker, the exchanges, and the clearing entities. Ultimately, the risks can affect the integrity of the market structure itself."*[70]

It is believed that the NASDAQ and SEC intend to address these concerns in the coming months. This has provoked a sharp response according to Trader's Magazine's *Gloves Off* article:

> *"Nasdaq may not have been angling for a fight, but it got one…Vendors don't want businesses that have grown handsomely jeopardized by new rules…."*[71]

The article lists the firms *"lobbying the SEC"* regarding the proposal as *"Wedbush Morgan, Penson Financial Services, FTEN Inc., Lava Brokerage, Electronic Transaction Clearing and OES MarketGroup."* These firms have some of the largest sponsored access relationships in the business.[72]

By contrast, the major and best-known broker dealers have been very slow in allowing sponsored access according to the *Traders Magazine* article:

> *"Goldman Sachs said it has only recently begun providing institutions with sponsored access."We're tiptoeing into it," said Rishi Nangalia, head of business development at Goldman Sachs Electronic Trading. 'We hadn't done it before and we didn't endorse it because we weren't comfortable with the technology, but now*

> *we're seeing improved technology that supports pre-trade, during-trade and post-trade monitoring for risks and market manipulation.'"*[73]

Likewise, Morgan Stanley and Credit Suisse offer more limited versions of sponsored access with strong trade monitoring and compliance. These firms appear to welcome greater regulation of the practice, presumably concerned about firms that fail to monitor client access.[74]

Combining the 15% of sponsored access with an additional 10-12% from dark pools suggests that approximately one-quarter of the entire market's trading is now conducted with minimal transparency as to who is responsible for the trade being placed. Another one-quarter of trades are likely from hedge funds through traditional brokerage relationships. **Putting it all together, it is clear that many trades are virtually untraceable in regard to who ultimately is pulling the trigger. Certainly there is sufficient room for someone or some group with nefarious intentions to conduct a significant amount of trading activity that could certainly destabilize the markets.**

One scenario could be that a terror group could direct investments to a feeder hedge fund. That feeder fund would locate a Cayman Islands-based hedge fund on their behalf that was predisposed to sell short financial shares. With sufficient new money, the hedge fund would expand their short selling activity (naked and traditional) and trade through dark pools or with sponsored access. At the same time, the same terror group might invest heavily in credit default swaps of the targeted short sales either directly, through foreign contacts, or hedge funds. This activity, focused initially on Bear Stearns would prove greatly profitable. The same activity refocused on Lehman Brothers could account for a significant portion of the 33 million failed-to-deliver (naked short) shares, providing the trigger for the market and economy to collapse. And, nearly all of it would occur without notice. In fact, the original investor could close out positions basically undetected.

**The reality of the situation today is that foreign-based hedge funds perpetrating bear raid strategies could do so virtually unmonitored and unregulated on behalf of enemies of the United States.**

Only recently have defense and intelligence agencies begun to consider this very real possibility of what amounts to financial terrorism and/or economic warfare. The author of this report, for example, circulated a White Paper on 12 December 2008 titled *"Economic Warfare Threat Exposed by Recent Market Turmoil."* It outlined the basic process of bear raids and suggested the very real possibility that these raids were undertaken as an act of financial terrorism.

A 26 February 2009 Associated Press (AP) report, **Recession, Bailout, Stimulus: US Security Threats** summed up the concerns:

> *"If terrorists or countries wanted to send U.S. financial markets into a tailspin, they would not need an explosion. Several financial doomsday scenarios have circulated in intelligence and financial circles. One goes like this: A foreign*

*government or a terrorist group with substantial financial backing sets up several overseas hedge funds. Acting together, they dump U.S. stocks, perhaps by short-selling a major financial index or by targeting key U.S. companies. The attack begins slowly, picking up speed over several hours as it creates panic and confusion in the market."*[75]

These are relatively new thoughts. Until very recently, however, economic issues were virtually excluded from the national security focus. That is despite the fact that the U.S. economy has been top of mind to terrorists. Again quoting from the AP report:

*"Security officials long have worried about threats to financial institutions. In 2004, police increased security at the New York Stock Exchange and elsewhere in response to a perceived al-Qaida threat. But the focus was on car bombs, suitcase nuclear weapons or hijacked airplanes, not economics. That's the way it has been for years. The FBI and the Homeland Security Department's joint report on potential terrorist attack methods last year did not mention economic sabotage. The Homeland Security's five-year threat assessment focused primarily on weapons of mass destruction, leaving the limited discussion about economic attacks to a section on computer hackers."*[76]

**Clearly, the risk is present and must be addressed. Other nations have well developed Economic Threat Doctrines and the U.S. intelligence services appear to be behind the curve in this area.**

## Unusual Trading Activity

Given the lack of transparency already discussed, there is obviously very little forensic evidence available to prove that an organized financial attack took place. Despite this, however, it is possible to note unusual trading patterns and draw some possible theories from them. The logical place to start would be by reviewing the available trading in the stocks of the financial services firms that appeared subjects of bear raids.

Based on NASDAQ market participant reports, an anonymous author submitted a paper titled *Red Flags of Market Manipulation Causing a Collapse of the U.S. Economy* to various law enforcement agencies as well as members of Congress and regulators. The report contains some startling statistics that would, on the surface, appear to support many of the concerns already discussed. Included among the key points of the 65-page paper are the following thoughts:

*"This report discusses extensive research that shows significant 'red flags' of danger to the world's economy from what appears to be market manipulation in the global financial markets, which includes trading in common stocks, options, futures, commodities, currencies, oil, and bonds.*

> *Two companies…are at the heart of this trading and they consistently work in concert. These firms became, virtually overnight, the largest traders in the U.S. financial markets. These companies provide a one-stop-shop for trade execution, back office clearing and bookkeeping that cater to hedge funds and small broker dealers. To give perspective, the amount of trading executed by these two firms in October 2008 exceeded the trading of securities firms Goldman Sachs, JP Morgan and Merrill Lynch combined in the NASDAQ market participant reports.*
>
> *Key points*
>
> 1) *The firms have traded trillions of dollars worth of U.S. blue chip companies. They are the number one traders in all financial companies that collapsed or are now financially supported by the U.S. government. Trading by the firms has grown exponentially while the markets have lost trillions of dollars in value.*
> 2) *These firms appear to own few or no shares of blue chip companies they are number one traders in. There is no doubt that the magnitude of their trading impacted the marketplace. Since the direction of the market place has been in a severe downward trend, the impact from the firms has been and remains, negative to the marketplace."*[77]

Some other starling findings in the report, based almost exclusively on reviewing basic trading data, include:

- The two previously small broker dealers mentioned in the report are market makers for every major financial services firm under attack.
- These firms have a combined 76 different symbols under which they act as market maker (by contrast a major firm such as Citigroup has just 6).
- Both firms offer sponsored access.
- Both firms offer access to dark pools.
- From June through September 2008, the two firms appeared to concentrate on Lehman Brothers, trading 1.04 billion shares while the stock price collapsed from $33.83 to $0.21 on 15 September. This pattern seemed to repeat in every other major financial stock.
- The report estimates that the two firms completed as many as 641,000 trades per hour in October 2008 (based on market participation statistics and average trade size from the last available data).
- Total trading volume by month in the financial sector listed for these two firms grew from approximately 350,000 shares (less than 1% of all market participant trading) in September 2006 to approximately 600,000 shares in the sector (about 6% of all market participant trading) in September 2007, to over 8 billion shares in the sector (about 19% of all market participant trading) by September 2008. That's an increase of 2.4 million percent in two years.
- While both firms have been around for several decades, their rapid growth began in 2006 for one and 2007 for the other.

- Both firms seem to specialize in the same stocks at the same time, appearing to work in concert.
- Combined, the two firms traded 203 billion shares, mostly concentrated in major financial services companies. This compares to a total of 427 billion shares outstanding of all issues on the New York Stock Exchange.
- The report estimates trading of at least $5 trillion over the 25-month period ending in November 2008.
- The trading appears to represent new money to the marketplace by new participants.
- From July 2008 through September 2008, the two firms "traded more shares of Fannie and Freddie than were issued" even as the share prices were collapsing.
- The firms were also the largest traders of the UltraShort funds as well as the "financial spider" (symbol "XLF") during the reporting period.
- The firms also became the largest traders of energy stocks.
- The two firms did not and do not hold major equity positions on their books.[78]

The names of these two firms have been purposely withheld in this report because trading data alone is insufficient to consider any accusations against them. But, this trading data is specifically the type of red flag that should prompt further investigation. In addition, even in the event that trades were entered with the purpose of manipulating markets, there is no evidence to suggest that either of the brokerage firms discussed had any knowledge of, or in any way participated in any wrongdoing. They simply could have been conduits through which orders were placed as the laws and regulatory authorities currently allow.

Nevertheless, this trading activity does lead to numerous questions:

- Who had the capital to effect $5 trillion worth of trades in such a short period?
- Who are the clients behind the trades? Are they foreign or domestic?
- Why would two long-standing but relatively minor broker dealers be selected for such massive trading rather than the major firms? Did they have more permissive rules for sponsored access?
- Why was trading concentrated in the financial firms that failed (Lehman, AIG, Bear Stearns, Fannie, Freddie) or were under threat of failing (Citigroup, Bank of America, Merrill Lynch, and Wachovia)?

## Considering the Suspects

Because the regulatory framework fails to require necessary disclosure (and in some cases prohibits it), the only way to evaluate potential suspects using publicly available (unclassified) data is by through a motive, means, opportunity analysis. In that regard, these suspects can be divided into two broad groups. One group would consist of those who might have a traditional profit (economic) motive. The second group that must be considered consists of those whose primary motive would be viewed as non-economic (where profits were not the primary concern) or subversive.

Economic players would include traditional hedge funds and short sellers who foresaw the economic difficulties, analyzed corporate balance sheet, and recognized regulatory weakness that would enable bear raids. This group can further be divided into two groups, those which acted legally simply taking advantage of circumstances and those which acted illegally, manipulating circumstances for profit.

There should be little doubt that there were hedge funds that simply took advantage of available market trends and circumstances to profit from the decline of the U.S. financial situation. A few well-known funds that showed strong profits during the period include George Soros' Quantum Fund which profited by $1.1 billion. It is worth noting that Soros is certain that bear raids were in play as described earlier in this report. Therefore, it is possible that his trading was "piggybacking" what he saw happening in the market.

The hedge fund rankings of *Alpha Magazine's* April 2009 edition provide insight into who made money and how much during the volatility of 2008:

> *"Although the hedge fund industry didn't escape the carnage of what many are calling the worst financial crisis since the 1930s, some managers are doing just fine, raking in money hand over fist. In 2008, in fact, four of them made more than the $1 billion that JPMorgan Chase & Co. paid for troubled investment bank Bear Stearns Cos. last spring in a shotgun merger orchestrated by the feds. James Simons of black-box fame at Renaissance Technologies Corp. earned a whopping $2.5 billion. He was trailed by John Paulson of Paulson & Co. ($2 billion), John Arnold of Centaurus Energy ($1.5 billion) and George Soros of Soros Fund Management ($1.1 billion). All but Arnold are repeat top-four finishers in Alpha's eighth annual ranking of the world's best-paid managers."* [79]

[*Alpha's* ranking of top-performing hedge funds in 2008 is provided in Appendix F.]

Overall, any gain is pretty extraordinary as the average hedge fund lost more than 21% in 2008, one of their worst years in history. The vast majority of funds lost money. There was only one class of hedge funds that was positive during the year, according to the Barclay Hedge Fund Index review of 2008 hedge fund performance:

> *"'Hedge funds lost a record 21.44% in 2008 according to the Barclay Hedge Fund Index compiled by BarclayHedge.2008 hedge fund losses were widespread, with 70 percent of the funds that report to us ending the year in the red . . . Managers of funds of hedge funds turned in an even poorer performance, with 85 percent finishing in the minus column, losing an average of 21.69 percent. Hedge funds began the year holding their own, with the Barclay Hedge Fund Index down just 0.79% through May. But the average fund lost 21.21% from June through November, including a two-month 14.81% decline in September and October when the S&P 500 Index fell 24.21%.* ***Only one hedge fund strategy was***

> ***profitable in 2008, and it thrived. The Barclay Equity Short Bias Index turned in a record gain of 41.09% in 12 months, and jumped 20.83% during the September and October stock market plunge."***[80]

It is reasonable to assume that most hedge funds that made money in 2008 were involved in short selling in some way (or very profitable early in the year and then moved to cash).

Given the hypothesis under consideration (that one or more entities may have attempted to invest in such a way as to harm the U.S. economy), it might be expected that larger and newer funds would likely outperform older/smaller funds. The reason for this expectation is simple. Larger funds would be required to have the market impact. Newer funds would be more eager for cash. For a fund to be both large and new would require a serious investment made more recently. While such analysis is far from conclusive, a reasonable analogy might be made to last-minute, high-dollar airline ticket purchases raising additional security concerns.

According to *Hedge Fund News*, typically small funds outperform large funds and new funds outperform old. In 2008, however, a new combination emerged with younger, large funds performing best:

> *"While previous research has confirmed the widely held belief that emerging funds tend to outperform older and larger funds, hedge fund performance in 2008 saw a partial reversal of that trend, according to PerTrac Financial Solutions in its third annual study that examines hedge fund returns, volatility and risk, based on age and size.*
>
> *Last year was a difficult one for hedge funds of all ages and sizes, but once again we saw younger funds outperforming older ones, confirming our findings from earlier studies," said Meredith Jones, managing director at PerTrac. 'However, when it comes to hedge fund performance as a function of fund size, we saw a reversal of the trend established from 1996 through 2007. During 2008, funds with the least assets actually performed the worst, while larger funds posted better returns.'"*[81]

**As discussed earlier, hedge fund gains do not indicate any level of wrongdoing by the funds themselves or their clients.** Having said that, if there were any wrongdoing, it is only logical to assume that it must have taken place through the funds that showed gains, with or without the knowledge of fund management. Pulling the data together, it is reasonable to believe that a large amount of money moved into newer hedge funds that focused on shorting the market.

Based on the data, the hypothesis of bear raids continues to be very plausible. Certainly there are hedge funds that fit the profile and one of the most astute fund managers, George Soros, acknowledged that bear raids were the primary source of the market turmoil. The motive question then becomes the primary consideration.

As already discussed, it is possible that the motive was purely economic even if the means were subversive. For example, many of those who claim that naked short sales have destroyed American companies also believe that organized crime is involved, including the Russian Mafia. Patrick Byrne, CEO of Overstock.com has long made such contentions as a part of his crusade to stop naked short selling. Starting with the assumption that naked short selling is profitable (and mostly illegal), it is not a far stretch to find this plausible.[82]

According to a posted *Free Republic* article:

> *"Bernard L. Madoff was once the chairman of the NASDAQ stock exchange. He was one of the most important market makers on Wall Street. And he managed what was, by some estimates, the largest hedge fund on the planet. Yes, Bernard Madoff was an impressive man. That much was clear even before we learned that his $50 billion Ponzi scheme may have been orchestrated in cahoots with the most powerful, sophisticated, and indiscriminately murderous organized crime syndicate the world has ever known.*
>
> *Charles Gasparino (citing "speculation" from investigators) reported last week on CNBC that the Russian Mafia might have been partners in Madoff's larcenous fund business. Or perhaps the Mob had an even greater interest in Madoff's market making operation, as some of our sources have told us in recent weeks."*[83]

The rumors about organized crime ties to Madoff gained additional credibility when the whistleblower on the Madoff case, Harry Markopolos, CFA, testified before Congress.

> *"Markopolos, an independent fraud investigator and former securities industry executive, has been cast as an unheeded prophet after the SEC ignored his repeated warnings about Madoff. The SEC "roars like a lion and bites like a flea" and "is busy protecting the big financial predators from investors," Markopolos said during his testimony in Washington.*
>
> *Madoff is accused of carrying out what may be the largest financial crime in history, scamming investors out of as much as $50 billion through a Ponzi scheme. When the SEC failed to probe allegations against Madoff, "I became fearful for the safety of my family," Markopolos told the House financial panel in prepared remarks. He added that he and those working with him "feared for our lives" during their investigation.* ***Markopolos elaborated while being questioned by lawmakers, alleging Madoff "had a lot of dirty money" from the Russian mafia and Latin American drug cartels.*** [84]

[The full text of the Markopolos testimony can be found here: http://www.house.gov/apps/list/hearing/financialsvcs_dem/markopolos020409.pdf.][85]

Overall, the theory suggests that such criminal elements learned how to naked short sell from 2001 through 2007 by attacking smaller, vulnerable stocks. Then, recognizing the market peak in 2007 began to look for larger and more profitable targets such as the U.S. financial services industry. Unfortunately, if the initial efforts were made through offshore funds, they would be virtually untraceable. Given the sophistication of modern criminal groups, it must be assumed that these efforts would be hidden through all available means.

## Those with Subversive Motives

Obviously, if it is possible for criminal elements to use subversive means with traditional profit motives, it must be reasonable to expect that subversive means could also be used to achieve subversive motives. The nature and scale of the bear raids provided the means. A clearly vulnerable system offered the opportunity. The only remaining element needed to identify suspects has to do with motive. For the hypothesis to be accurate there must be sufficient motive.

At first glance, the greed motive seems reasonable enough. Yet, upon further analysis it is possibly insufficient to explain the extraordinary carnage in the markets. Certainly there were numerous opportunities for profit but the nature of the bear raids appears to have been more directly targeting the overall system than maximum profit. This was noted by Barry Ritholtz, the head of research firm FusionIQ who Steve Forbes called one of the most *"insightful minds on Wall Street today."* Ritholtz is well-connected and respected on Wall Street and writes a daily blog called, *The Big Picture*. His 19 September 2008 comments, contemporaneous with the failure of Lehman, were:

> *"Last night, we discussed the absurdity of banning all short sales. The details of the SEC action have been released). The specifics are a "temporary halt in short selling in 799 financial institutions" until October 2nd. I have been trying to contextualize this, and I keep coming back to what seemed like a wild theory yesterday that seems a whole lot less wild today. During the day, I had an interesting phone conversation with Joe Besecker of Emerald Asset Management.*
>
> *But Joe is a good money manager, a great stock picker, and a thoughtful guy. He raised an intriguing issue: None of the many hedgies he knew were pressing their bets recently. The bear raids on the banks and brokers were NOT a case of piling on by US based hedge funds. And from what he was seeing and hearing about in terms of order flow, the vast majority of the financial short selling the past week or so were being done overseas. It appears that the lion's share of shorting was coming out of overseas bourses such as London and Dubai. It may not be a coincidence that the financial short selling ban is both here and in London.*
>
> *Then there is another coincidence: The huge increase in shorting of the financials occurred on the anniversary of 9/11. And on top of that, the same institutions attacked on 9/11/01 were the ones suffering in recent days."*[86]

Unfortunately, given the panic at the time, there was virtually no follow up on the theory. All of the focus was directed toward "healing" the system. Yet, the premise remains essentially intact. The vast majority of well-known and more-established U.S. located hedge funds were not pressing their bets. The confusion was too great and profit-motivated hedge funds moved to the sidelines for the most part. Much of the business was coming through London or Dubai. And, the shorting of the financials did begin on the anniversary of 9/11.

These sentiments were echoed by the flamboyant Jim Cramer of *CNBC's Mad Money*:

> *"Cramer suggests the damage being done to stocks through short selling, where Wall Street's most legendary institutions are losing value at alarming rates, could be the work of financial terrorism. Cramer's been talking to the short sellers he knows, and that's the theory they've been putting forward. His sources said that it's doubtful that the market's traditional short sellers are behind the negative action we've seen lately. So there is the possibility that someone else has been trying to wreak havoc in the markets rather than just profit from the problems of Goldman Sachs. Cramer, who was merely relaying what he heard, did say that, given the fact that the U.S. is in a "financial nationally emergency," the "financial terrorism thing, to me, has to be put on the table just because the regular short sellers are not doing this." The Mad Money host urged the U.K.'s Financial Services Authority, which just banned short selling in financial stocks and now requires stricter disclosure from short sellers, to find out who's on the other side of these trades."*[87]

Beyond the rumors of Wall Street, well-respected national security experts Charles Duelfer (former director of the Iraq Survey Group) and James Rickards (former general counsel of Long Term Capital Management and noted Threat Finance expert) co-authored an Op-Ed in the 21 December 2008 New York Times titled Financial Time Bombs. Their article provides strong expert support for the hypothesis:

> *"The economic crisis has made it painfully obvious that the United States economy has become very vulnerable to broken gears in the global financial system. But this is not simply a financial or economic problem — it is a grave national security risk, and our government must treat it as such."*[88]

Duelfer and Rickards identify some potential suspects for economic disruptions such as China, Russia, and even Al Qaeda:

> *"Al Qaeda has declared that damage to the American economy is its second most important goal after mass casualties. Presently, who would warn the White House if foreign entities made a concerted attack on our financial system? Who is charged with detecting such activity?"*[89]

They also provide support for the method of some of the analysis contained in this report -- examining unusual trading patterns and data:

> *"There is a tremendous range of global threat indicators that can be gleaned from careful scrutiny of trading activity. For example, in August 2006 an unexplained decline in certain airline stocks took place shortly before the arrests in Britain of terrorists plotting to blow up trans-Atlantic airliners."*[90]

## The Motive of Financial Jihad

A powerful analysis of financial jihad was contained in a July 2005 article published in *Small Wars Journal* by Shawn O'Connell (Adjunct professor of Rhetoric at St Thomas University in Miami, FL). The article, titled **Economic Terrorism: *The Radical Muslim War Against the Western Tax Base*** traces the history of radical Muslim attacks in the form of financial jihad. The introductory paragraph provides a powerful summary:

> *"This paper outlines a theory concerning why Muslim terrorists attacked the World Trade Towers on Sept. 11, 2001, bombed London's subway during the G-8 economic summit on July 7th, and detonated blasts in an Egyptian resort on 23rd July.* ***The reason for these attacks was to create 'Economic Terrorism.' Economic Terrorism is defined here as the attempt to assault and destroy a foe through decimation of the enemy's tax base via rank economic sabotage. Such attacks on economic infrastructures lower net tax yield, thereby shrinking the capital pool for military spending.*** *There is historical warrant for the belligerent use of strategic economic destruction. This is detailed in an iconoclastic book on the Roman Empire's demise, by peerless Orientalist Henri Pirenne, called 'Charlemagne and Muhammad' (1943). This work challenged Gibbon's thesis that Germanic barbarian assaults doomed Rome, posited in the Decline and Fall of the Roman Empire (1776). As we shall see, 'Economic Terrorism' is the most potent weapon for Muslim radicals can deploy in their siege against the West. There is hard evidence Islamicists employed Economic Terrorism on Sept. 11 to mangle the US economy, which vicariously damaged the tax base. By extension, this was meant to prune U.S ability to pursue aggressive foreign policy, mount defense and wage war. Radical Islam has long reacted with ambivalence and rage towards capitalism. Framing this debate is a larger ideological struggle, pitting 'atheistic' Western capitalistic economics against the Islamic idee fixe – the formulaic Muslim theocracy. Accordingly, a famous radical Muslim intellectual felt that, "…democracy is a form of idol worship. So, too…capitalism, which is…is a form of idolatry." We now know Al Qaeda was fixated on casing New York financial institutions for years before they attacked*. ***If Islamic terrorists further pursue Economic Terrorism without an organized Western response, the impact upon economy and tax-derived defense will be massive. Also, such attacks won't be isolated, but recurrent -- given the small cost of assaults and massive potential reward. Therefore, we must study Economic Terrorism and prepare an answer. Ultimately, as the poor and overmatched Islamic terrorists pursue their struggle against the West, they realize this is the best 'small war' strategy of all.***"[91]

It is clear from both public statements as well as past efforts that Osama bin Laden has a clear desire to harm U.S. economic interests. In his 21 December 2001 message:

> *"There is much to say about these grave events. However, I will talk briefly and concentrate on the need to continue the jihad action, militarily and economically, against the United States. Praise be to God, the United States has declined.* ***The economic bleeding is continuing to date, but it requires further strikes.*** *The young people should make an effort to look for the key pillars of the US economy.* ***The key pillars of the enemy should be struck, God willing****.*
>
> *They shook America's throne and struck at the US economy in the heart. They struck the largest military power deep in the heart, thanks to God the Almighty. This is a clear proof that this international usurious, damnable economy -- which America uses along with its military power to impose infidelity and humiliation on weak people -- can easily collapse. Thanks to Almighty God, those blessed attacks, as they themselves admitted, have inflicted on the New York and other markets more than a trillion dollars in losses.*
>
> ***…hitting the economic structure…is basic for the military power. If their economy is destroyed, they will be busy with their own affairs rather than enslaving the weak peoples. It is very important to concentrate on hitting the US economy through all possible means."***[92]

This is a very clearly stated motive by Bin Laden. In addition, we know that he has a fascination with the U.S. financial markets, specifically targeting the Twin Towers in 2001 to strike at the heart of Wall Street. There should be no doubt that Al Qaeda has sufficient motive as well as the cleverness to have carried out a financial attack. It is not clear, however, that the organization, by itself, has the financial resources. According to a recent report by Richard Barrett:

> *"Financial problems take a serious toll on al-Qaeda's ability to run its organization effectively. Even the group's leadership in the Afghan-Pakistani border area must pay for food, living quarters, accommodations for families of fallen comrades, and security, both in terms of hiring guards and in buying the silence of their neighbors. In addition, the leaders need money to recruit and train operatives and to mount operations."*[93]

[Richard Barrett is the coordinator of the al-Qaeda, Taliban Monitoring Team, appointed by the United Nations Secretary-General to support the UN Security Council's 1267 Committee.]

Of course, Al Qaeda's limited resources would not necessarily provide a complete impediment to carrying out financial attacks. The group has extensive ties globally including with the cash-rich Taliban (based on global drug sales), Iran, Russia, radicals in the Arab states, China, and Venezuela. Paul William published a book in 2005 titled *The Al Qaeda Connection—International Terrorism, Organized Crime, and the Coming Apocalypse,* that specifically outlines ties with the Russian Mafia and other drug gangs. [94]

One example of Al Qaeda ties can be found in a claim by Venezuelan defectors that Hugo Chavez has been financing their activities, beginning with a $1 million donation in 2002:

> *"High-level military defectors reveal new terrorist links between Al Qaeda and Venezuelan strongman Hugo Chavez. The man who controls the largest oil reserves in the Western hemisphere gave $1 million to the world's most wanted terrorist right after the 9/11 attacks. Hugo Chavez would not admit it publicly, but in private, he was very impressed with Osama Bin Laden's work."*[95]

For his own part, Chavez has demonstrated sufficient animosity against the U.S. financial system to be considered a suspect in his own right. An Associate Press story quotes the Venezuelan leader:

> *"Speaking to Venezuelan state television late Thursday, Chavez said* ***'Capitalism needs to go down. It has to end. And we must take a transitional road to a new model that we call socialism.'*** *The Venezuelan leader's comments came during a trip to Iran. In recent years, Chavez and Iran's hard-line President Mahmoud Ahmadinejad — both well-known for their anti-U.S. rhetoric — have boosted economic and political ties."*[96]

In conjunction with his April speech, Chavez embarked on a world tour echoing the message that "Capitalism must go down" in meetings held in Teheran, Qatar (for a summit of Arab states), Beijing, and Moscow. In each case, his visits emphasized economic ties in defiance of Wall Street. One example:

> *"The largest banks in the world sunk but we are making a bank, said Venezuelan President Hugo Chavez when he arrived Wednesday to Tehran, where on Thursday he will meet with his Iranian counterpart Mahmud Ahmadinejad and inaugurate a bank backed by the two nations. Chavez is making his seventh visit to Iran in an effort to increase active cooperation He was received at the Tehran airport by the Minister of Industry and Mines, Ali Reza Tahmasbi, reported EFE. The main topic on the agenda for Chavez's visit is the opening of the bi-national bank, which will begin to operate with an initial capital of US $1.6 billion, the same amount with which the Venezuela-Iran Fund will also operate."*[97]

It is interesting to note that Hugo Chavez is listed as "the most popular leader in the Middle East" based on a recent Zogby poll:

> *"The results of the new survey of Arab opinion conducted by Zogby International…put the President of Venezuela at the top of the poll. The survey,*

*which was conducted in April and May 2009, sampled the views of 4,087 people in Egypt, Saudi Arabia, Morocco, Lebanon, Jordan and the United Arab Emirates. According to the respected Zogby polling organisation, the poll has a margin of error of plus or minus 1.6%. One of the questions put to the participants was "which two world leaders (outside your own country) do you admire most?" The most frequently named leader is Hugo Chavez, at 36%. Following Chavez in order of admiration are Syrian leader Bashar al-Assad and former President of France Jacques Chirac (both at 18%), Osama bin Laden (16%), Mohammed bin Zayed, the Crown Prince of Abu Dhabi (15%) and the current French president Nicolas Sarkozy (14%). Admiration in the Arab countries for Hugo Chavez has hugely increased since 2008."*[98]

This, of course, ties back to radical Islam which has popular support in the various nations that were surveyed. The ties that bind are primarily economic as well as deep-seated hatred toward the United States. This reality was noted by Matthew Clark of the *Christian Science Monitor* in his 20 May 2009 article reporting the Zogby poll:

*"In March, Chavez went before Arab leaders in Doha, Qatar, to propose an oil-backed currency to challenge the US dollar. There, he gleefully announced the demise of 'the Empire' - or 'the Great Satan.' 'A new world is being born,' Chavez said then. 'Empires fall. There is a world crisis of capitalism, it's shaking the planet.''"*[99]

Of course, other organizations, even those with similar goals, view Al Qaeda as competitive or even a threat. The key, however, is recognizing that those who seek to displace capitalism and the United States economy have common goals and share a common enemy. At times, these groups may seek to work together and at other times may be at odds.

*"One of the most alarming findings of a new poll of attitudes in four Muslim countries (Egypt, Pakistan, Morocco, and Indonesia) is that a majority of respondents say they support two of Al Qaeda's chief goals: They want strict Islamic law, or sharia, in Muslim countries and to 'unify all Islamic countries into a single state, or Caliphate.'"* [100]

## Shariah Compliant Finance

*"Shariah is an all-embracing body of Islamic religious, social, political, and military duties developed by caliphs and Shariah authorities over 1200 years. It is imposed as the law of the land in Saudi Arabia, Iran, and Sudan and, until recently, in Afghanistan by the Taliban. Adherents to traditional, authoritative Islam seek to impose the repressive, theocratic program they call Shariah on everyone, Muslims and non-Muslims alike.*

> *The primary purpose of Shariah is to promote Islam as the only legitimate theo-political system and to accomplish its dominance, through violent Jihad if necessary worldwide (this is what is meant by the 'Islamist' agenda)."* [101]

These two quotes from page two of the book, *Shariah, Law and Financial Jihad: How Should America Respond?* (published by the McCormick Foundation, 2008) describe the radical jihadist view of Shariah law. While those who adhere to the Shariah philosophy might not be allied with Al Qaeda, **they no doubt agree wholeheartedly with the primary motivation of imposing Shariah law globally through whatever means necessary.** The dedication to Shariah crosses both Sunni and Shi'a legal schools of Islam. In this view, Muslims are either pro-Shariah or apostate. There is no middle ground.

**Peaceable Muslim groups may define jihad as "a personal struggle." This may represent the majority of Muslim individuals.** Sadly, there is another large group with a long historical tradition that views jihad as the struggle to impose Shariah. For this group, within jihad, there are two primary elements of the fighting, one with weapons of traditional warfare and the other with money. According to the *Qur'an*, in chapter 61, verses 10.11: *"you...should strive for the cause of Allah with your wealth and your lives,"* and chapter 49, verse 15: *"The [true] believers are only those who...strive with their wealth and their lives for the cause of Allah."* The financial aspect is known as financial *jihad*, or *Al Jihad bi-al-Mal*.

According to Saudi and Muslim Brotherhood (MB) spiritual leader Hamud bin Uqla al-Shuaibi, ***"The importance of Financial Jihad [is]...more important...than self-sacrificing."***[102]

Mahathir Mohamed, as prime minister of Malaysia, founded the Islamic Financial Services Board (IFSB) in 2002 to develop a "universal Islamic banking system" with the purpose of abolishing the "slavery" of the Western international monetary system. Prime Minister Mohamed has a unique viewpoint on the monetary system, having had his nation as the subject of a bear raid supposedly perpetrated by George Soros in 1997.[103]

[Mahathir Mohamed and George Soros had a long-standing public dispute that began with Soros short-selling the Malaysian currency in 1997. Soros called for Mahathir Mohamed to be ousted from power and in response, Mohamed called Soros a "moron." The two "buried the hatchet" in a December 2006 meeting according to an Associate Press report from Kuala Lumpur.][104]

In other words, radical jihadists have the specific and particular goal of abolishing the Western financial system and replacing it with something that would be subject to Shariah law. That something is known as Shariah Compliant Finance (SCF) which may be the fastest growing economic system in the world.[105]

**Shariah Compliant Finance is perhaps the single most important intersection point for radical jihadists and the financial system. This is not to say that everyone who**

**participates in SCF is motivated to do harm to the western economies. But, it can be said that a majority of jihadists who desire to harm western economies would be adherents to SCF.**

According to an article published in Accountancy, *Shariah-compliant Financial Products* by Muhammad Ashraf:

> *"The most pronounced difference between Islamic financing (SCF) and existing equivalent products is the prohibition of interest. This is based on the principle that it is unacceptable in and of itself for same commodity, including money, to increase in value merely by being lent to another person. However, Shariah does not prohibit the making of a return on capital if the provider is willing to share in the risks of a productive enterprise."*[106]

Shariah Compliant Finance has grown substantially over the past two decades with an estimated 15% to 25% annual growth rate.[107] Total assets are now approaching three-quarters of a trillion dollars according to a 25 May 2009 report from Ernst and Young:

> ***"The 3rd annual Ernst & Young Islamic Funds & Investments Report (IFIR 2009), released today at the World Islamic Funds and Capital Markets Conference states that Shari'a sensitive investable assets in 2008 in the GCC and Asia touched US$736 billion as compared to US$267 billion in 2007."***[108]

It should be noted that the funds discussed here do not include the significant amount of additional assets held by Sovereign Wealth Funds (SWF) and "royal family funds" (held by members of the ruling families) that adhere to Shariah principles, together would be estimated at well over $1 trillion.[109]

## The Intersection of SCF and Sovereign Wealth Funds

One of the areas that demands additional study is the intersection between Shariah Compliant Finance and Sovereign Wealth Funds. This is important because it has already been demonstrated that at a minimum, certain SCF proponents have indicated an historical desire to take down the Western economic system and replace it with Shariah. In the aftermath of the 2008 economic collapse, this idea was certainly discussed by Shariah supporters. A wide variety of articles in Muslim newspapers proclaimed the death of capitalism and ascension of Shariah economics. This fact was documented in a 15 December 2008 article, *Islamic Banking and the Collapse of Capitalism*, written by Lahem Al Nasser in *Asharq Al-Awsat,* the world's premier pan-Arab daily newspaper.

> *"The global financial crisis has shaken the foundation of capitalism all over the world, from the rich North to the poor South, from democratic regimes to dictatorial ones. Voices were raised everywhere; I am talking of course about the Muslim writers and intellectuals who predicted the collapse of capitalism, and the*

> *bankruptcy of capitalist countries, announcing that the Islamic financial system would soon prevail."*[110]

A very public example of this thinking can be found in the FAQ section of the Islamic Invitation Center website:

> *"Q: Is Islam against Capitalism?*
> *A: Yes. Capitalism is based on the concept that economics is that which examines man's needs, which are unlimited and how to satisfy these unlimited needs. The system depends upon the separation of church and state or in other words, the separation of the Creator from life's affairs. The concept of freedom plays a major role in the Capitalist ideology. The Islamic economic system is derived from the only source that is capable of satisfying the needs and desires of everyone, without resulting in chaos. The source of these rules is our Creator.*
> *"**Seek the abode of the Hereafter in that which Allah has given you, and neglect not your portion of the world., and be kind as Allah has been kind to you and seek not corruption in the earth.** " Qur'an."*[111]

In a special section on the public website, additional elaboration is presented:

> *"The Islamic economic system is just a part of Islam. It cannot be separated from it and discussed as an individual component. Islam ordered the Muslims: "Seek the abode of the Hereafter in that which Allah has given you, and neglect not your portion of the world., and be kind as Allah has been kind to you and seek not corruption in the earth. [Translated meaning from Quran in English]."*[112]

Therefore, to the degree that Sovereign Wealth Funds follow Shariah practices, there should be legitimate concern regarding the motive these funds may have while appearing to participate benignly in Western capitalism. Do the SWFs really follow Shariah, and if so desire to see capitalism fail? Or, perhaps do the SWFs pay lip service to Shariah but in actuality are capitalist in nature?

The McCormick Foundation report outlined these concerns:

> *"…very little attention has been paid to date to another disturbing dimension of SWF – their increasingly close and synergistic relationship with Shariah-compliant finance in the Muslim world in general, and the Gulf in particular. Given the explosive growth of SCF compared to conventional banking in the Gulf and the strong government support behind this trend, it is very likely that SCF and Gulf-based SWF are rapidly becoming one and the same phenomenon. This would mean that—at some point in the near future, if not already—SWF will become an instrument for promoting and legitimizing Shariah in the West."*[113]

In the aftermath of the 2008 economic collapse, that has already begun. Arab-based sovereign wealth funds have already begun rumblings that they will make no further investments in the West unless they are Shariah compliant. These threats even extend to

U.S. banks which have been desperate enough for capital that many have added SCF products to their lineup. This was recently reported in a *Washington Times* article by Frank Gaffney, Jr.:

> *"The U.S. Treasury Department is submitting to Shariah …Deputy Secretary of the Treasury Robert Kimmitt set the stage with his recent visit to Saudi Arabia and other oil-rich Persian Gulf states. His stated purpose was to promote the recycling of petrodollars in the form of foreign investment here.*
>
> *Evidently, the price demanded by his hosts is that the U.S. government get with the Islamist financial program. While in Riyadh, Mr. Kimmitt announced: "The U.S. government is currently studying the salient features of Islamic banking to ascertain how far it could be useful in fighting the ongoing world economic crisis."* [114]

The ties between SCF and SWF are becoming increasingly obvious in other ways as well according to the McCormick report including:

- ***Strong government support for Shariah-compliant finance throughout the Gulf****. For instance, the huge Dubai Holding concern owned by Sheikh Maktoum, has recently been acquiring existing Islamic banks and sponsoring new ones. The Dubai-government owned Dubai International Financial Centre (DIFC) intends to become an international center for "Islamic finance regulations, standards and practices" by creating 'an Islamic hedge fund platform, an Islamic finance portal, a commodity exchange (murabaha) and Islamic finance institutes.'*
- ***Interlocking directorships between Islamist Shariah-compliant finance, sovereign wealth funds and sovereign wealth****. For example, Sheikh Maktoum's right-hand man and chief investment officer, Soud Baalawy is simultaneously the chairman of the Noor Islamic Bank, executive chairman of the Dubai Group and vice chairman of Bourse Dubai, the world's biggest bourse for Islamic bond (sukuk) listings.*
- ***Direct sponsorship and financial support by Persian Gulf rulers for Shariah-centered Islamists and Shariah banks****. The two Islamic banks in Qatar (the International Islamic Bank of Qatar and the Islamic Bank of Qatar) are both owned by the ruling Thani family and have the strident Islamist Sheikh Yusuf Al Qaradawi as the chairman of their Shariah advisory boards.*[115]

There is a great deal of evidence to support the idea that Sovereign Wealth Funds in Muslim nations are heavily connected to Shariah Compliant Finance. In addition, based on the evidence as well as public statements, it is plain that SCF seeks to displace Western-style capitalism. Putting this together with the large asset base and low transparency of sovereign funds provides a basic rationale for the funds to be considered as potential suspects in our basic hypothesis. Again, this is not to say that everyone

involved in SCF intends ill toward the Western financial system. But, it can be said that there are those who are using SCF against capitalism.
Two additional considerations, however, must be explored:

1) Would SWF have sufficient access to the markets?
2) Would SWF have the capability to participate in short selling given their adherence to Shariah?

The first question can be answered very directly in the affirmative. Sovereign funds have direct access to U.S. markets through hedge funds and various trading platforms including dark pools. One example was described in the 26 May 2009 edition of Hedge Funds Review:

> *"As one of the leading investment banks in the Arab world, EFG-Hermes brings a large network and access to liquidity pools across the main markets in the Middle East, including Egypt, Saudi Arabia, Kuwait and the UAE."*[116]

The second question then becomes whether or not SWF might be allowed to sell short as required to conduct a modern bear raid. This is not a minor consideration. As already documented, the nature of Shariah compliance does call for proof of superiority over capitalism. This could be accomplished by the failure of interest-based banking institutions. But, Shariah historically has had prohibitions against selling what was not owned (short selling). This creates a paradox. Sovereign Wealth Funds would be motivated to attack capitalism by Shariah but prohibited from doing so by Shariah.

Interestingly, the paradox appears to have been resolved in mid 2007, almost precisely at the stock market peak. The resolution was well-documented by *The Wall Street Journal* in a 9 August 2007 article titled, *When Hedge Funds Meet Islamic Finance*:

> *"One recent afternoon, New York money manager James Rickards presented Sheik Yusuf Talal DeLorenzo with a dilemma: Could his hedge fund be Islamic friendly? Islam prohibits all kinds of speculative behavior that is embedded in Wall Street's DNA. But Mr. DeLorenzo, a Massachusetts-born convert to Islam, is on a mission to meld centuries-old Islamic law with modern finance in the U.S. Mr. Rickards' fund couldn't bet on currency futures or some of the shares in the Standard & Poor's 500 index, Mr. DeLorenzo said, if he wants observant Muslims to invest. But some alterations could earn the sheik's approval -- such as holding currencies instead of futures, and buying only S&P 500 companies that aren't debt-heavy or dependent on profit from interest payments. 'Music to my ears,' Mr. Rickards said. 'It sounds like I can still get the effect I'm looking for.' With the Middle Eastern economy booming, partly thanks to soaring oil wealth, the Islamic financial industry has been expanding at a clip of about 15% a year, according to accounting firm KPMG, and is on pace to reach $1 trillion in two years. The money is seeking new outlets and Western financial institutions are seeking new clients -- opening the door for more aggressive methods to reconcile two worlds that don't easily mesh.*

> *London-based Barclays Bank PLC, which worked with Mr. DeLorenzo and a firm called Shariah Capital Inc. on a platform for hedge funds to trade without violating Islamic requirements, had to rewrite a 20-oddpage brokerage contract. The concept of short-selling -- using borrowed shares to bet on a stock's decline --was replaced with an Islamic down-payment structure known as an arboon.”*[117]

The purpose of the “arboon” is to have the same impact as short selling, that is, to profit from the decline in value of a security. Barclays Bank and Shariah Capital have gone to great lengths to demonstrate that while the approach is Shariah compliant, it also has the effect of selling shares short. What shares would make ideal short-sale targets? Since Shariah followers would be discouraged from buying the shares of interest- and debt-based institutions, banks would be ideal targets. This is certainly implied in *The Wall Street Journal* article:

> *Mr. DeLorenzo is pushing the envelope with an even more complex product, the Islamic trading system for hedge funds he helped develop with Barclays and Greenwich, Conn.-based Shariah Capital. In the summer of 2001, Shariah's CEO Eric Meyer was a hedge-fund manager looking for a new venture. He was impressed by Mr. DeLorenzo's writing on Islamic finance. He sought him out and the two men talked for more than five hours about how to create an Islamic hedge fund. Mr. DeLorenzo had his doubts. Hedge funds' variety of complex investment strategies -- including "short selling" stocks by selling borrowed shares to bet their price will drop -- poses a problem. In Islamic finance, investors aren't allowed to sell what they don't own because it represents an unacceptable form of speculation.*
>
> *There are other prohibitions, too. Because of the ban on interest payments, investors must avoid companies like banks that rely on interest for their income. For the same reason, they are required to steer clear of firms that carry high levels of debt -- defined in different rulings as around one-third of either market capitalization or assets -- and thus pay a significant amount of interest.”*[118]

The process of allowing short selling appears to have been complex, but resolvable. It not only provided “moral justification” for short selling but also provided the required connection between Shariah-based institutions and hedge funds according to the *Journal* article:

> *“Mr. DeLorenzo and other well-known scholars began by breaking down the entire process of the traditional short sale "in excruciating detail," recalls Mr. Meyer. Some of the scholars' questions stumped even seasoned short-selling pros. One example: If an investor borrows shares in a company, and that company goes bankrupt, who has voting rights?*

*Questions like that were "just exasperating," Mr. Meyer says. "You're thinking, 'It's bankrupt, what does it matter?' But in Islamic finance, you always need to know ownership and control" to make sure the risk is shared among the parties. After months of meetings in London and New York, Mr. DeLorenzo and his fellow scholars adapted the arboon contract -- akin to a down payment that enables the short-seller to take ownership of the share, rather than just borrowing it. To address avoiding companies with too much debt or other issues under Islamic law, Shariah Capital developed new screening software. It taps directly into the quarterly reports that companies file electronically to the Securities and Exchange Commission and weeds out businesses that carry high amounts of debt or reap significant income from interest payments.*

*Mr. DeLorenzo now holds the title of chief Shariah officer for the company and can tap into the software and monitor what's being traded at any time. Two U.S. hedge fund firms have signed up to use the trading platform so far, and Mr. Rickards, the New York hedge-fund manager, is considering joining them."*[119]

It should be noted that similar interpretation efforts have been conducted to allow commodity investments:

*"Abu Dhabi Investment Authority, the world's largest such fund with an estimated $875 billion as of September, invests 5 percent to 10 percent of that amount in hedge funds and commodity trading advisors, according to Euromoney magazine. 'The model for the large sovereign funds is similar to that of the leading U.S. university endowment funds, such as Yale, Harvard and Princeton,' Richard Kushel, a managing director at Blackrock, a money management firm, told Euromoney. 'They were early adopters of absolute return strategies and placed much greater emphasis on alternatives [such as commodities] and less on short-dated liquid instruments," such as bonds.*

*Mideast funds are especially keen on gold, as a hedge against inflation and the falling dollar. Those gold purchases have helped push the precious metal to recent record highs. Sovereign funds have played a role in sending oil prices to new peaks as well. They are turning to commodities as a safe haven from the turmoil in financial assets, says T. Okoshi, an economist at Nomura Holdings."*[120]

It should be understood that the official law of Abu Dhabi is Shariah. Further, Abu Dhabi is viewed as very progressive in SCF, having introduced a Shariah-compliant VISA card with the features of a credit card while avoiding the appearance of forbidden interest.

Sovereign Wealth Funds have varying degrees of transparency (see Appendix H). The least transparent may provide nothing more than basic contact information such as a telephone number. As a general rule, SWF in oil-producing states trend to be among the least transparent.[121]

**No direct evidence has been uncovered to suggest that the Abu Dhabi or any other SWF participated in bear raids during 2008. But, the example has been shown that a Shariah-compliant SWF now has the ability to sell short either through SCF-compliant hedge funds or directly via the arboon short sale. This recent change along with the lack of transparency requires careful consideration.**

Exact details and size of short positions are very difficult to obtain due to the secretive nature of the funds. What is known, however, is that these funds have taken large stakes in major U.S. financial institutions. Saudi Prince bin Talal, for example, manages a royal fund and has been one of the largest holders of Citigroup shares for nearly two decades.[122]

Likewise, the Abu Dhabi government announced the taking of a 4.9% stake in Citigroup for $7.5 billion in December 2007.[123] At first glance, such stakes might appear to preclude any possible short-sale of financial companies. Upon further consideration, such large stakes might actually create a need to have short selling as a hedge against long holdings. It would be difficult to reduce or eliminate their major holdings given public scrutiny. But, using hedge funds and dark pools, it would be possible to take substantial short positions to offset the exposure. There is likely also a tipping point at which the profits from short selling would exceed the losses from long holdings.

It is very interesting to note, for example, that the Saudi Prince's Kingdom Holdings fund publicly claimed a loss of more than $8 billion during the fourth quarter of 2008 according to a 21 January 2009 Reuter's report:

> *"RIYADH, Saudi Arabia (Reuters) — The Kingdom Holding Company, owned by the Saudi billionaire Prince Walid bin Talal, posted a $8.26 billion net loss in the fourth quarter after a drop in the value of its assets, including a substantial stake in Citigroup."*[124]

This public claim of loss was accompanied by complaints regarding the failure of capitalism. It should also be noted, however, that when the accountants for The Kingdom Holding Corporation published a local report on the fund's performance in the 4th quarter of 2008, they actually showed a slight gain:

> *"RIYADH (Reuters) - Kingdom Holding Co., owned by Saudi billionaire Prince Alwaleed bin Talal, said on Saturday that it had revised its fourth-quarter earnings to show a small overall profit after initially reporting a net loss close to $8.3 billion. The revision followed the completion of an examination by Kingdom Holding of its preliminary financial earnings for 2008 and a 're-categorization of some items of its income statement,' according to a statement posted on Saudi bourse website. Based on this 're-categorization,' the company said, Kingdom Holding showed an "overall" profit of 276 million riyals ($73.6 million).*
> *The company reported on January 20 a Q4 net loss of 30.97 billion riyals ($8.26 billion) after a dive in the value of its assets, which include a substantial stake in*

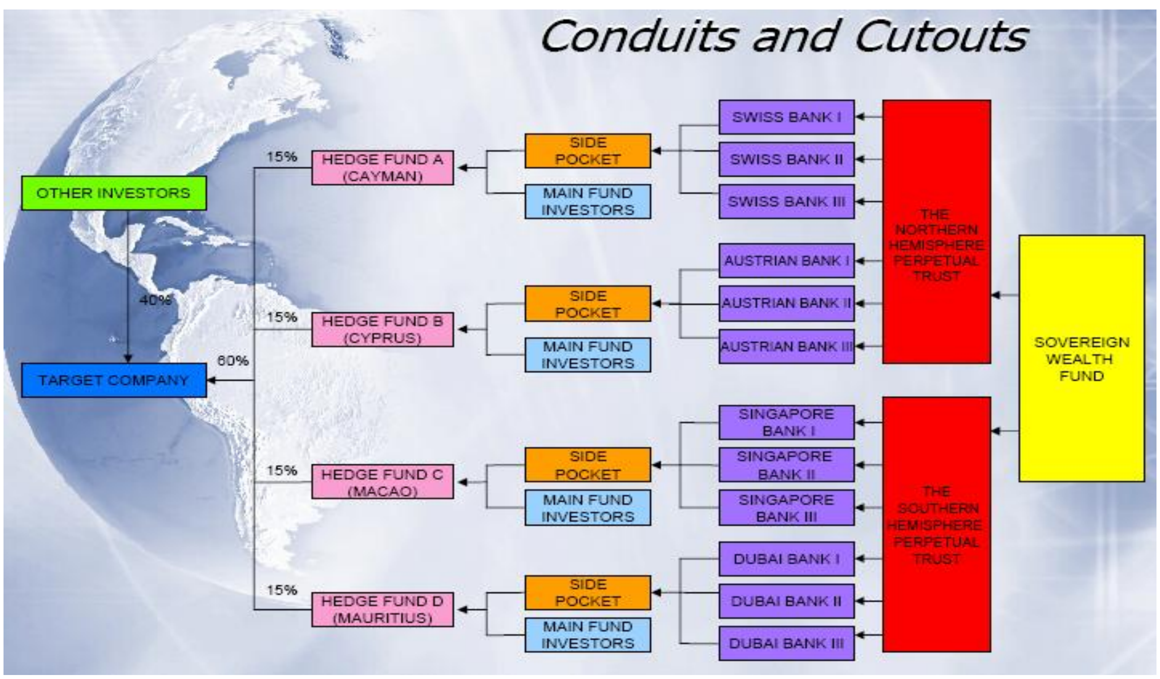
*Citigroup. Kingdom's spokeswoman Heba Fatani declined to immediately comment on the official stock market disclosure."*[125]

There may be a number of legitimate explanations for how an $8.3 billion loss converts to a $73.6 million profit. One of them, however, could be that the fund was hedged, implying substantial short positions. Unfortunately, like most SWF, Kingdom Holdings offers virtually no transparency and traditionally operates in secrecy.

One final note in this regard is the understanding that the Shariah-driven investor, by definition, elevates long-term considerations well above short-term profits. While this view is too-often lacking in Western finance, the long-term approach will allow for strategic short-term loss to accomplish greater purposes. Therefore, the fact that SWF may have lost money in the decline does not in any way rule out a possible participation in the bear raids. In fact, given the large excess cash reserves available to the sovereign funds, price declines would be considered a real positive as they would allow greater future influence.

The Chart below from a James Rickards presentation illustrates the difficulty in tracing investments back through a complex hedge fund structure back to a Sovereign Wealth Fund.

**Complex Web of SWF Investments through a Maze of Hedge Funds**[126]




**The bottom line is that the intersection of SWF and SCF, with the addition of hedge funds and the "arboon" short-selling mechanism offers a reasonable assumption of motive, means, and opportunity for the conducting of bear raids designed to bring down the U.S. financial system. This alone is sufficient to demand additional research as well as considerations of potential counter-measures and responses.**

## Other Suspects

While the emphasis of consideration has been on the Arab states, it should be noted that Iran, Venezuela, Russia, and China also have substantial Sovereign Wealth Funds sufficient to have accomplished massive bear raids. In the case of Iran, Russia, and Venezuela, as major oil exporters, all three enjoyed more than sufficient prosperity in the first six months of 2008 to more than offset the short-term losses from the market's decline. As noted earlier in this report, Iran and Venezuela in particular have been vocal regarding a desire to see the U.S. economic system collapse. At the same time, these nations had both the means and opportunity.

Russia has tremendous criminal elements with substantial resources that are sufficient to provide motive, means, and opportunity. In addition, these elements have sufficient ties with Iran, Venezuela, and jihadist elements. George Soros was recently quoted as saying that Russia, Iran, and Venezuela *"are the enemies of the global world order."*[127] Finally, there are the previously mentioned rumors of Russian mafia influence on Wall Street.[128]

In terms of China, the economic decline certainly had negative aspects, including but not limited to a decline in global consumption of Chinese produced goods. There were positive aspects as well, including lower raw materials prices and an enhanced long-term position. This point was made clear by a recently released Goldman Sachs report:

> *"MOSCOW (Reuters) - The global crisis means China and other emerging market powers will overtake developed world economies even more quickly, the Goldman Sachs economist who coined the BRIC concept told Reuters. Goldman Chief Economist Jim O'Neill said China's economy was now likely to overtake the United States in less than 20 years time and the four BRIC countries combined -- Brazil, Russia, India and China -- could dwarf the G7 over the same period.*
>
> *'Their relative rise appears to be stronger despite the rather pitifully thought out views by some a few months ago that the BRIC dream could be shattered by the crisis,' he said in a telephone interview from London."*[129]

This provides both a profit and political motive for China assuming a longer-term viewpoint, which is very compatible with the historical Chinese perspective.

It should be noted that a very recent case brought by Manhattan District Attorney Robert Morgenthau contains interesting elements involving Russia, China, Iran, and the global banking system. Morgenthau has brought a case that suggests that in the Iranian drive to obtain nuclear weaponry, presumably from Russian sources, a Chinese individual helped to launder funds through a variety of global banks. The significance is that this makes the key elements behind the hypothesis in this paper very realistic. There should be no doubt that when given the opportunity, a number of global players have the means and motive to pursue agendas that are very contrary to American interests.

According to a 6 March 2009 *Fox News* report:

> *Famed Manhattan District Attorney Robert M. Morgenthau warned Congress on Wednesday that Iran's efforts to build nuclear weapons and ballistic missiles pose a "deadly serious" threat to the United States. The legendary prosecutor -- whose pursuit of white-collar criminals has spanned the globe -- told the Senate Foreign Relations Committee that he has uncovered a pervasive system of deceitful practices and fraud designed to let Iran's banks skirt U.S. and international sanctions. Sources told FOX News that the Morgenthau probe into Iranian money laundering schemes is broad and ongoing. So far, the Manhattan DA has struck a plea deal with a British bank and, separately, indicted a Chinese citizen and his company on charges related to Iran's violations of international sanctions designed to block its acquisition of nuclear weaponry.*
>
> *In the British case, Lloyds Bank admitted it had engaged in a "stripping" scheme designed to hide the Iranian origin of more than $300 million in wire transfers. Bank coding information indicating an Iran address for the money was "stripped" from wire transfers. Some of Iran's biggest banks -- blacklisted by the U.S. and international agencies for their alleged role in nuclear armament and terror funding -- are believed to have played a role in the illegal money movement. Lloyds paid $350 million in fines and is cooperating with a joint investigation by Morgenthau and federal authorities. The British bank shut down the stripping scheme in 2004, well before law enforcement learned of the activities. According to published reports, Morgenthau is investigating at least nine other banks for similar practices.*[130]

There are other very recent developments that are supportive of the financial terrorism/economic warfare theory as well. The first is the 6 April 2009 announcement by Swiss authorities of concerns that "moles" have infiltrated their banking system according to *Intelligence Online*:

> *"Jurg Siegrfied, who has run Switzerland's Service d'Analyse et de Prevention since the beginning of the year, indicated that 21 foreign diplomats suspected of spying, and notably financial espionage, had been forbidden to set foot in the Confederation since last year."*[131]

This underscores that economic/financial espionage is real and ongoing. This fact is further supported by the recent revelation of huge sums of money counterfeited and laundered by North Korea. According to excerpts from an exclusive report in *The Washington Times:*

> *"A North Korean general who is a confidant of the country's leader, Kim Jong-il, has been identified by U.S. and foreign intelligence agencies as a key figure in the covert production and distribution of high-quality counterfeit $100 bills called supernotes, according to documents and interviews with intelligence officials.*

> *North Korean Gen. O Kuk-ryol, who was recently promoted to the country's powerful National Defense Commission, and several of his family members are said to be in charge of producing the fake $100 bills, which are so carefully crafted that they are difficult to tell apart from real U.S. banknotes.*
>
> *A foreign-government report obtained by The Washington Times from a diplomatic source in Washington said Gen. O has emerged in recent months as one of the most powerful military figures in the North Korean regime and the person in charge of arranging the succession of Mr. Kim by his third son, Kim Jong-un. Kim Jong-il suffered a stroke in August and has appeared in public recently looking thin and frail. The information about the general in the report was confirmed by a senior U.S. intelligence official as well as by other current and former officials with knowledge of North Korean activities. They asked not to be named because of the sensitivity of the issue…*
>
> *David Asher, former State Department coordinator for tracking North Korean illicit activities, said in a speech in February that the Banco Delta Asia case involving North Korean counterfeiting was 'the tip of the iceberg' in Pyongyang's global moneymaking operations. Mr. Asher said undercover FBI agents in Macao documented the activity, including counterfeiting, that involved 'hundreds of millions of dollars' until the bank was sanctioned. 'Banco Delta Asia was washing massive amounts of money,' he said, noting that more steps need to be taken to halt Pyongyang's illicit activities and arms trafficking…*
>
> *The report says North Korea uses front companies and shell companies overseas to facilitate the illicit trafficking in supernotes. The use of fake companies increased after the Treasury Department barred U.S. companies from working with Banco Delta Asia.*
>
> *To further hide the transactions from international financial authorities, the North Korean party office used a financial front company, set up in China in 2006, to make payments as part of the purchases, the report says. North Korea also set up a front company in the British Virgin Islands in the mid-2000s to take advantage of lax banking regulations and tax laws there, it says, and other branches of the front company were established for financial support activities in China, Russia and Southeast Asia."* [132]

As shocking as the counterfeiting report was at the time, **it pales in comparison to the even more recent report of Japanese individuals attempting to smuggle $134 billion in U.S. Federal Reserve bonds into Switzerland from Italy.** According to the TimesOnline:

> *"Italian prosecutors were trying to establish yesterday whether US bonds with a face value of $134 billion seized from two alleged smugglers were real or counterfeit. The bonds were found when the two men — said to be Japanese but as yet not identified — were arrested while attempting to cross into Switzerland*

> *from Italy by train at the frontier town of Chiasso this month. Prosecutors in Como said that the two men had hidden the bonds in the false bottom of a suitcase.*
>
> *Police said that Chiasso was a notorious crossing point for currency and bond smugglers but the sums involved this time were "colossal". The amount of $134 billion would place the two travellers as the fourth most important investors in US debt, well ahead of Britain ($128.2 billion) and just behind Russia ($138.4 billion). The bonds were described as being 249 US Federal Reserve bonds each worth $500 million, plus ten Kennedy bonds with face values of $1 billion, in addition to various other types. Police said that the two men had stayed at a hotel in Milan last Tuesday. Instead of taking the express train to Lugano, they had boarded a slow commuter train from a suburban station to attract less attention.*
>
> *Although Switzerland and Italy adhere to the Schengen accords on frontier-free travel, customs officers from both sides who still watch travellers became suspicious, Italian reports said. Police said that there was cause for concern even if the bonds turned out to be forgeries, since it would amount to a counterfeiting scam 'on an unprecedented scale.'"* [133]

**The sheer amount of the bonds takes the activity out of the role of the criminal and into the realm of financial terrorism and/or economic warfare.** The questions raised are of the highest gravity. Non-sophisticated criminals would not see any purpose to counterfeiting in such large amounts. It would be a waste of time as the fakes would be so readily dismissed. More sophisticated actors, particularly at the nation-state level, would have to have a far more subversive purpose to undertake such an act, beyond a simple attempt to acquire cash. Such actors would clearly understand that the bonds could not be passed in the normal course of economic events. Rather, their use would be limited to points of near chaos where they might be deemed real for a short period. Or, perhaps they could be placed on deposit and used as collateral for other efforts, including the concept of selling short against the box. If U.S. bonds were sold short in that quantity, it would be sufficient to cause a panic run on the dollar. Then, for delivery the paper (presumably counterfeit) bonds could be delivered. This would be a variation of naked shorting in which virtually counterfeit shares are created.

**The mere existence of the bonds in that quantity, whether counterfeit or real, lends substantial credence to the economic warfare theory. In fact, these bonds could represent some of the money transfer that may be taking place now following the Phase One oil ramp and the Phase Two bear raids. Most concerning of all is that the very large transfer may even have been preparation for a coming Phase 3 assault on the Western financial/economic system.**

There can no longer be doubt that an economic war already could be underway as this is written. Unfortunately, unless proper action is taken immediately to uncover this potential risk, it may only be discovered too late.

# Phase Three: Collapse the Dollar, Bankrupt the Treasury

While Phase One and Phase Two were troubling, the U.S. economy eventually was able to respond and the markets stabilized. Unfortunately, the response has saddled the U.S. Treasury with substantial debt. At the same time, the Federal Reserve has massively increased the money supply in response. In total, an estimated $12.8 trillion of economic stimulus has been put into the pipeline by the U.S. government and monetary authorities as shown in the following table. The following table from Bloomberg News details how the Fed and the government have committed the money on behalf of American taxpayers over the past 20 months:

Estimated Fiscal and Monetary Stimulus Commitments[134]

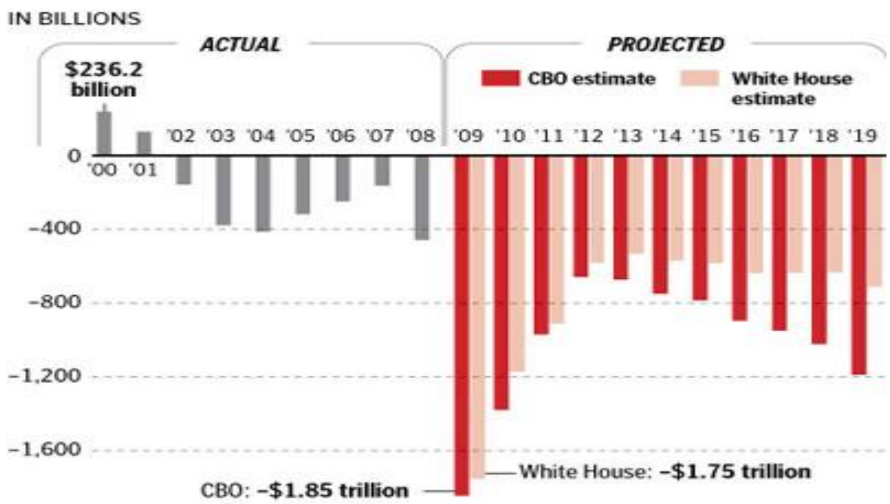
| | --- Amounts (Billions)--- | |
|---|---|---|
| | Limit | Current |
| Total | $12,798.14 | $4,169.71 |
| Federal Reserve Total | $7,765.64 | $1,678.71 |
| Primary Credit Discount | $110.74 | $61.31 |
| Secondary Credit | $0.19 | $1.00 |
| Primary dealer and others | $147.00 | $20.18 |
| ABCP Liquidity | $152.11 | $6.85 |
| AIG Credit | $60.00 | $43.19 |
| Net Portfolio CP Funding | $1,800.00 | $241.31 |
| Maiden Lane (Bear Stearns) | $29.50 | $28.82 |
| Maiden Lane II (AIG) | $22.50 | $18.54 |
| Maiden Lane III (AIG) | $30.00 | $24.04 |
| Term Securities Lending | $250.00 | $88.55 |
| Term Auction Facility | $900.00 | $468.59 |
| Securities lending overnight | $10.00 | $4.41 |
| Term Asset-Backed Loan Facility | $900.00 | $4.71 |
| Currency Swaps/Other Assets | $606.00 | $377.87 |
| MMIFF | $540.00 | $0.00 |
| GSE Debt Purchases | $600.00 | $50.39 |
| GSE Mortgage-Backed Securities | $1,000.00 | $236.16 |
| Citigroup Bailout Fed Portion | $220.40 | $0.00 |
| Bank of America Bailout | $87.20 | $0.00 |
| Commitment to Buy Treasuries | $300.00 | $7.50 |
| FDIC Total | $2,038.50 | $357.50 |
| Public-Private Investment* | $500.00 | 0.00 |
| FDIC Liquidity Guarantees | $1,400.00 | $316.50 |
| GE | $126.00 | $41.00 |
| Citigroup Bailout FDIC | $10.00 | $0.00 |
| Bank of America Bailout FDIC | $2.50 | $0.00 |
| Treasury Total | $2,694.00 | $1,833.50 |
| TARP | $700.00 | $599.50 |
| Tax Break for Banks | $29.00 | $29.00 |
| Stimulus Package (Bush) | $168.00 | $168.00 |
| Stimulus II (Obama) | $787.00 | $787.00 |
| Treasury Exchange Stabilization | $50.00 | $50.00 |
| Student Loan Purchases | $60.00 | $0.00 |
| Support for Fannie/Freddie | $400.00 | $200.00 |
| Line of Credit for FDIC* | $500.00 | $0.00 |
| HUD Total | $300.00 | $300.00 |
| Hope for Homeowners FHA | $300.00 | $300.00 |

The FDIC’s commitment to guarantee lending under the Legacy Loan Program and the Legacy Asset Program includes a $500 billion line of credit from the U.S. Treasury.

Source: Bloomberg News Last Updated: March 31, 2009 14:20 EDT

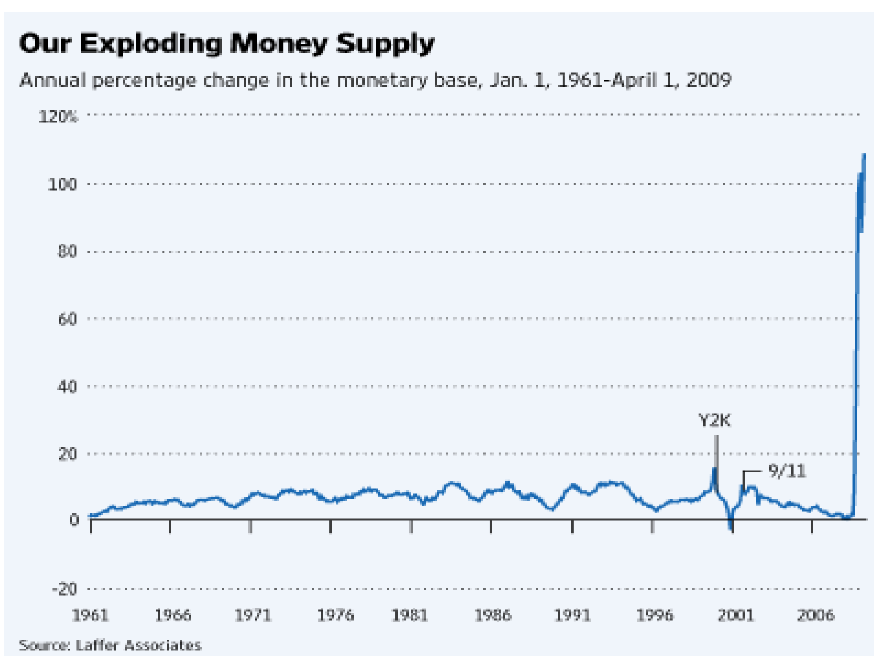
For context, $12.8 trillion is roughly in line with total U.S. GDP and sharply greater than the value of all U.S. stocks at current prices. It is also roughly equivalent to the amount of price decline for all American assets, peak to trough, as a result of the financial crisis. It also is estimated to produce massive annual Federal budget deficits as shown in the chart.

**Actual vs. Projected Federal Budget Deficits**[135]




Source: Heritage Foundation, http://blog.heritage.org/2009/03/24/bush-deficit-vs-obama-deficit-in-pictures/

At the same time, the monetary response has serious inflationary considerations as well. This can be seen in a stunning chart provided by Laffer Associates in an Op-Ed published in the 11 June 2009 issue of *The Wall Street Journal*:




Source: Laffer Associates[136]

The concern is that the response to the recent collapse by itself will strain available economic resources for some time with large budget deficits and high inflation risks. The situation would be made significantly worse in the event of further economic attack. It is in this vein that a potential Phase Three must be considered.

Based on the assumed nature of Phase One and Phase Two, a Phase Three attack would likely involve dumping of U.S. Treasuries and a trashing of the dollar, removing it from reserve currency status. This is clearly foreseeable as a risk and even could float under the cover of a natural outcome in much the same way that Phases One and Two potentially have been hidden.

The implications are extremely serious. If the dollar were not the reserve currency, there would be a mass dumping of Treasury instruments by foreign holders. Treasury interest rates would skyrocket, further worsening the annual deficits due to sharply higher interest payments on expanding debts. The Treasury would have to raise taxes dramatically, further dampening growth or the Federal Reserve would be forced to monetize the debt, worsening inflation concerns. Pushed to the limit, could the U.S. dollar would follow the path of the German currency in Weimar Germany following defeat in World War I. These concerns were raised recently in a NewsMax article by Hans Parisis:

> *"German Chancellor Angela Merkel has now put aside the German tradition whereby politicians do not publicly criticize central bank policies. In a speech, she instead took them head on. 'I am very skeptical about the extent of the Fed's actions and the way the Bank of England has carved its own little line in Europe. Even the European Central Bank has somewhat bowed to international pressure with its purchase of covered bonds. … We must return to independent and sensible monetary policies, otherwise we will be back to where we are now in 10 years' time.'*
>
> *While it still isn't clear what triggered Ms. Merkel's unusual strong remarks, which came in a prepared speech, it is clear that German officials are starting to worry we could see in the coming years (and not just months) too much money chasing, proportionally of course, too few goods and services. Yes, the Germans haven't forgotten the lessons of the 1920s hyperinflation during the Weimar Republic, when on Nov. 1 1923, one pound of bread cost 3 billion German marks; one pound of meat, 36 billion German marks, and 1 glass of beer, 4 billion German marks.*
>
> *To get somewhat of an idea about the value of the German currency at that time; during the first half of 1922, 320 marks bought $1. By December 1922 you needed 8,000 marks to buy $1. At the peak of inflation, in November 1923, the German mark became practically worthless. Inflation ended with the introduction of the "rentenmark" that was secured by real estate (yes, a tangible!), and the Weimar Republic continued for a decade afterwards. It is widely believed that this hyperinflation period has contributed to the Nazi takeover of Germany.*

> *These remarkable strong words of the German chancellor, whereby she openly criticizes the Fed's and Bank of England's quantitative easing policies shouldn't be taken lightly at this moment where big dollar holders like China, Saudi Arabia, etc. and the investing community as a whole have their clear worries about the future value of the dollar."*[137]

Those concerns would be sharply elevated if a concerted, planned attack were undertaken by holders of dollar-based instruments. As already explained, the largest holders of U.S. reserves, dollars and Treasury debt include China, Russia, and the oil producing states.

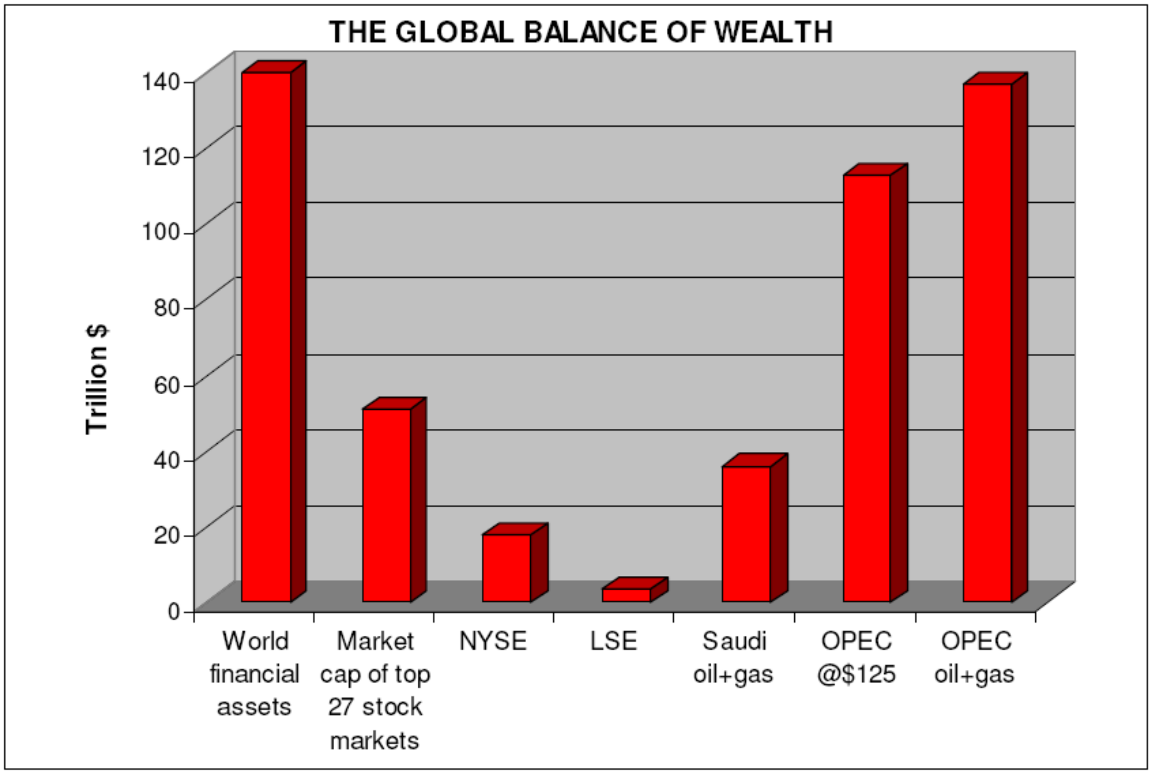
Financial Threat expert James Rickards was quoted in the *Politico:*

> *"'**The Number One vulnerability is the dollar itself,' Rickards concluded**. 'We're printing them and shoving them out the door, and the Fed is basically out of bullets. So why hasn't the dollar collapsed? The short answer is, global investors don't have any other choice.' That is, there simply aren't enough Euro- or Yen-backed securities for investors to shift their money out of dollars and into some other currency.*
>
> *But what if some kind of global coalition – say a trillion-dollar sovereign wealth fund allied with several countries around the world – banded together to create a gold-backed alternative to the dollar?*
>
> *Rickards says investors – many of whom already resent that they have no alternative to the dollar – would sell American currency in huge numbers to take advantage of the new opportunity. 'If that happens, that's the end of the dollar,' Rickards said. 'You'd have high unemployment, deflation, and interest rates would go up. It would take what already looks like a strong recession and make it a Great Depression or worse.'"*[138]

The balance of economic power has already shifted substantially over the past few years as described by Dr. Gal Luft in his 21 May 2008 testimony before Congress:

> *"As Robert Zubrin points out in his book Energy Victory, in 1972 the U.S. spent $4 billion on oil imports, an amount that equaled to 1.2% of our defense budget. In 2006, it paid $260 billion which equals to half of our defense budget. In 2008, it is likely to pay over $500 billion which is equivalent to our full defense budget. Over the same period, Saudi oil revenues grew from $2.7 billion to roughly $400 billion and with it their ability to fund radical Islam. In the years to come this economic imbalance will grow by leaps and bounds."*[139]

Dr. Luft presented a chart that showed that the value of OPEC's proven oil and gas resources was $137 trillion (when oil was $125/barrel). This was roughly equivalent to the world's total financial assets—stocks, bonds, other equities, government and corporate debt securities, and bank deposits—or almost three times the market capitalization of all the companies traded in the world's top 27 stock markets (in mid 2008).[140]




Source: Dr. Gal Luft, 21 May 2008 Congressional Testimony[141]

U.S. military strength hinges on economic well being and innovation. These facts are well understood by our enemies, prompting the desire to change the balance of power. Even though the price of oil has come down considerably since last summer, it has been rising again recently. Could this be in preparation for a Phase Three attack?

Walid Phares highlights this risk from jihadists in his blog with a quote from noted terrorist Ayman Zawahiri:

> *"Ayman Zawahiri called expressly and repetitively on the public to sell their US dollars and buy gold instead (Be'u al dullar washtaru al zahab). These were stunning statements ignored by most analysts at the time but that are making sense today. He predicted a collapse in the infidels' economy, starting from American markets. Was he a part of the lobbying effort in the OPEC game? Most likely not, but he seems to have been privy to the game, having insiders in the Wahhabi radical circles in the Peninsula: in the end there are too many political signs to dismiss and the analysis of price warfare is too evident to ignore."*[142]

A story in Abu Dhabi Media Company's TheNational, titled *Dawn of Sharia-compliant gold trading*, written by Uta Harnischfeger:

> *"NASDAQ Dubai yesterday launched the region's first Sharia*-compliant tradable *security backed by gold to satisfy a growing demand for the precious metal as a safe haven in the global recession. The product, which trades in the same way as an equity share and tracks the price of gold, is aimed at the region's high*-net-*worth individuals who are looking to diversify their portfolio, while conforming with Islamic investment principles.*
>
> *Named Dubai Gold, the product will allow them to invest in the metal without taking physical delivery. Each share initially represents one tenth of an ounce of gold. 'There is a huge demand for Sharia*-compliant products in the region. You *can use this product to diversify your portfolio. We are the gateway... and just made it very easy to buy gold,' said Jeffrey Singer, the chief executive of NASDAQ Dubai. Pradeep Unni, a research analyst at Richcomm Global Services in Dubai, said: 'We have seen huge inflows into gold... and these kinds of products could imitate their huge success in the US.' Investors are fleeing to gold as a means to preserve their wealth amid the fallout from the world economic crisis . . .'The product could also become interesting for the region's sovereign wealth funds,' said Marcus Grubb, the managing director at the WGC…"*[143]

In addition to the Phase Three risk from Sovereign Wealth Funds in Oil Producing areas, there are also serious rumblings from the BRIC countries (Brazil, Russia, India, and China) regarding the need for a new reserve currency. These nations are all large holders of dollars and desire to diversify in order to reduce their risk. Like the oil producers, the BRIC countries have considerable clout due to their above-average long term growth rates. A recent analysis by Goldman Sachs' chief economist even demonstrates that despite the economic downturn, the BRIC nations have strengthened their relative position as reported in China Daily:

> *MOSCOW -The global crisis means China and other emerging market powers will overtake developed world economies even more quickly, the Goldman Sachs economist who coined the BRIC concept said Goldman Chief Economist Jim O'Neill said China's economy was now likely to overtake the United States in less than 20 years time and the four BRIC countries combined - Brazil, Russia, India and China - could dwarf the G7 over the same period.*
>
> *'Their relative rise appears to be stronger despite the rather pitifully* thought out *views by some a few months ago that the BRIC 'dream' could be shattered by the crisis,' he said in a telephone interview from London. O'Neill invented the term BRIC in 2001 when he forecast that Brazil, Russia, India and China would overtake some of the world's top economies in the first half of the 21st century, becoming building blocks of a new world order.*
>
> *'We now conceive of China challenging the US for number one slot by 2027 and ... the combined GDP of the four BRICs being potentially bigger than that of the G7 within the next 20 years,' he added. 'This is around 10 years earlier than when we first looked at the issue.' Goldman is forecasting that the world economy*

*will contract by 1.1 percent this year while BRIC economies will grow by an average of 4.8 percent, O'Neill added.*

*'They are dominating the world growth picture even more than when the world was booming, and this is despite a revised very weak forecast for Russia in 2009,' he said. 'China has had a good crisis. In terms of China's role in the world the crisis has arguably been very helpful because it has forced China to realize that the next stage of their development cannot be led by export growth.'*

*Goldman is forecasting Chinese growth of 8.3 percent in 2009 and 10.9 percent in 2010, while it sees the world economy growing by just 3.3 percent next year. India is predicted to grow at an average rate of 6.3 percent from 2011 to 2050, China 5.2 percent, Brazil 4.3 percent and Russia - constrained by forecasts of a declining population - just 2.8 percent . . .*

*O'Neill said the idea floated by Zhou Xiaochuan, governor of the People's Bank of China, to make the International Monetary Fund's Special Drawing Rights (SDR) the basis of a new supranational currency was a fascinating idea. He said he thought the idea meant that China would have to allow more convertibility of the Yuan and that the idea of including Yuan in the SDR in six years' time was conceivable."*[144]

Clearly, there are risks to the U.S. position even without a preemptive economic attack. Given the weakened position, however, would an attack be that hard to imagine? Not according to *Politico*, which published an article titled *A Sneak Attack on the Dollar?*

***"The war began with a press release.***

***Dated May 13, 2010, it came from the Central Bank of the Russian Federation and said the Russian government 'hereby announces the following facilities and processes which are in place and available for counterparty inquiry immediately.'***

*Sounds innocent enough, but savvy investment experts got the message: It was the opening salvo in a sneak economic attack on the U.S. dollar.*

*The Russian Central Bank was creating a new global currency, the 'gold reserve dollar,' which would be issued by a financial agent in London and backed by tons of Russian gold shipped to secure vaults in Switzerland, the press release said.* **The goal: to drive the value of the U.S. dollar down by 75 percent overnight and wreak havoc on the struggling American economy**.

*Thankfully, the press release was a fake. It was written by economic intelligence analyst James Rickards and presented on March 24 to the Unrestricted Warfare Symposium at the Johns Hopkins University Applied Physics Laboratory. But Rickards' point was all too real:* **The American dollar is vulnerable as never**

> ***before to attack from hostile foreign governments. And the consequences of such an attack could be devastating.*** *'The result is that the U.S. would reimport the hyperinflation which it has been happily exporting the past several years,' Rickards wrote. 'U.S. interest rates would skyrocket to levels last seen in the Civil War, in order to preserve some value in new dollar investments.'"*[145]

Unfortunately, these "checkmate" scenarios are entirely possible after nearly two decades as the world's sole superpower. It is clear that American economic strength is under siege and this threatens our military power and our very way of life.

In order to prepare for a possible Phase Three, it is essential to have clarity regarding whether or not attacks have already occurred as hypothesized in Phases One and Two. Only then can a rational response be prepared. At present, the U.S. economy remains the largest and most powerful in the world. With proper evaluation, planning, and response, we can recognize that it is in an economic war and prepare for victory. If, however, we continue to ignore these realities, the American experiment of freedom and capitalism will end in failure and defeat.

[It should be noted that although we have listed Sovereign Wealth Funds as possible suspects in this hypothesis, Phase Three as outlined would be very damaging to many of their holdings. While it would likely prove beneficial to oil producers, since oil prices tend to move opposite the dollar and rise with inflation, it would definitely produce global economic chaos, something many SWFs would rather avoid. The issue becomes, therefore, whether the motive is economic or non-economic. A radical jihadist would certainly be willing to risk global collapse if it brought about global Shariah. Sadly, the existence of suicide bombers demonstrates the reality that some individuals will suffer the greatest personal harm in pursuit of jihad. Hopefully, the Sovereign Funds are more economic in their approach. The problem is that it's not possible to determine with certainty.]

# CONCLUSIONS

There is no question that the collapse of Lehman Brothers triggered the economic heart attack that began on or around 9/11/2008. That crisis has led to additional economic weakness and may have turned a bad recession into near depression.

While the economy was vulnerable due to substantial leverage and regulatory holes, there is substantial justification to consider the hypothesis that a concerted economic attack may have taken place, targeted initially against U.S. financial institutions. In fact, this theory is supported by experts including hedge fund managers, regulators, former regulators, academics, and many others. There is also some unusual trading activity that appears suspicious at a minimum, and may in fact provide the forensic proof upon further investigation.

For those who would argue that such a scheme could not go undetected, or that the FBI, SEC, spy agencies, or regulators would have noticed, the Congressional testimony of Harry Markopoulos, CFA regarding Bernie Madoff is very instructive. For more than a decade, there were specific and direct warnings placed before the primary regulatory bodies and law enforcement agencies. Despite this, Madoff was allowed access at the highest levels and even to create public policy. A serious lack of transparency and a “hands off” approach to the markets allowed what is alleged to be a fraud that cost its victims nearly $50 billion.[146]

**The hypothesis discussed in this paper suggests the very real possibility that financial terrorism may have cost the global economy as much as $50 trillion, roughly 1000 times greater than Bernie Madoff’s fund and equal to nearly four years of American productive output.**

Potential suspects include the vast and growing Sovereign Wealth Funds, supported by substantial excess oil revenues. While a number of experts have attempted to dismiss out of hand any fears of nefarious activity by Sovereign Funds, this ignores the reality that government owned funds are or will be political in nature over time. As a case in point, Venezuela’s acquisition of CITGO that began in 1986 and was completed in 1990 was considered very benign. Since then, however, Hugo Chavez rose to power with an agenda to harm the United States and destroy capitalism. Imagine the impact if CITGO were more strategically significant. The point being that even currently friendly sovereign funds could over time become unfriendly. This is especially true in nations with strong radical jihad movements.

**Even as the stock market appears to have stabilized somewhat, there is a new and increasing risk of financial attack. This attack actually poses a greater risk to American well-being than either the oil price ramp or the collapse in stock prices. The potential damage to U.S. sovereignty is unfortunately quite high and must be addressed almost immediately.**

# POLICY RECOMMENDATIONS

**Given the critical nature of the hypothesis of economic war/financial terrorism outlined in this paper, a plausible state of emergency may well exist. The preponderance of evidence that cannot be easily dismissed demands a thorough and immediate study be commenced. Given the seriousness of the concerns along with the apparent influence of outside forces on our bureaucratic government, it is strongly recommended that the immediate review be undertaken by private sector experts outside of traditional Wall Street influence.**

A number of immediate additional policy recommendations emerge from this study. Some of these are currently under consideration. Others should be immediately addressed.

Those under consideration that should be strongly considered and implemented in some reasonable format:

1. Require transparency for hedge funds that will show who the clients are and provide access to all trading records on a trail. Implement anti-money laundering laws.
2. Regulation of CDS with limits on the amount that can be "insured" relative to the nominal debt. Limit use to those with an insurable interest.
3. Eliminate naked short selling by mandating delivery of shares. Eliminate broad exceptions.
4. Reinstate the uptick rule in some enforceable format.
5. Eliminate the Enron loophole in oil trading.
6. Mandate U.S. based regulation over critical trading platforms (including the ICE oil trading).
7. Use international pressure to force greater Sovereign Wealth Fund transparency when accessing U.S. capital markets.
8. Streamline regulatory authority.

**The challenge will be to not destroy efficiency via regulation but instead to focus efforts to track down the perpetrators and properly respond. Ignoring the likelihood of this very real threat ensures a catastrophic event.** Therefore, in addition to the above, it is deemed essential also to do the following:

1. Recognize that protecting the American economy and industrial capability is a top defense priority that should be properly funded and supported. While non-combat in nature, economic warfare is essential to protecting the American way of life.
2. Prepare a task force to thoroughly research the hypothesis of economic warfare described herein from an economic defense perspective.
3. **Create a specialized threat finance unit to develop and implement appropriate countermeasures to emerging threats in coordination**

**with key defense, intelligence, and financial agencies, preparing targeted global responses as needed.**

4. Hiring and training of experts and consultants to support economic/financial threat recognition and awareness in various departments with redundancy.
5. **Recognize that many Wall Street and DC-based experts may have inherent conflicts of interest due to connections with hedge funds or others that may have been complicit in market attacks. Likewise, existing regulators who long overlooked problems may not be the best candidates for addressing the problems. Finally, traditional defense and intelligence agencies may not have the economic expertise to analyze or address the complexities of this situation. Therefore, due to the magnitude and seriousness of the risks, these efforts are best served outside traditional agencies and departments.** [This follows the historical precedent from the inception of intelligence agencies in the late 1930s based on concerns of Nazi infiltration at the initial stages of World War II.]

# Appendix A:
# Understanding the Risks of Credit Default Swaps

Credit default swaps were created by JP Morgan in 1994. There primary purpose is to provide a mechanism whereby bond investors could insure their loans against default. This allowed the lender to free up capital reserves that would normally be maintained in case any loans went bad. Those seeking to insure their loans would buy the swaps, in essence paying a fee to another party in exchange for a promise to be compensated in the event of a default. The counter-party that sold the swaps was essentially insuring against default and receiving a premium. As with most forms of insurance, the greater the risk of default, the higher the premium charged.[147]

Swaps are complicated by five additional factors. First, the industry lobbied for and was granted an exemption in 2000 that allowed them to remain unregulated. They were exempt from traditional insurance regulations and other state laws.

The lack of regulation created the second complication in that it became possible to essentially buy insurance without an underlying interest in what was being insured. Bucket shop laws were introduced after the 1907 financial crisis to prohibit betting on securities without some stake in the underlying asset for good reason. Imagine the problems that would be created if it were possible to buy fire insurance on buildings other than by the owners. Laws prohibit this specifically to prevent a financial incentive for arson. Likewise, laws prevent the taking out of life insurance policies by individuals without relation to the one insured. This prevents the creation of financial incentive to murder. Yet, with credit default swaps it has been possible to profit from the default of a company without any interest or risk in the underlying firm. George Soros explained the risks in a recent interview:

> *"'In fact, some derivatives ought not to be traded at all. I have in mind credit default swaps." The recent bankruptcies of General Motors and Abitibi Bowater show the damage that CDS can cause, Soros explains. 'In both cases, some bondholders owned CDS and stood to gain more by bankruptcy than by reorganization.* ***It is like buying life insurance on someone else's life and owning a license to kill him.*** *CDS are instruments of destruction that ought to be outlawed.'"*[148]

The third complicating factor is that an unlimited amount of swaps could be written and bought on any issuer. In some cases, the notional value of outstanding CDS contracts was as many as 10 times the value of the debt being insured. Because these are private contracts, sellers of swaps might also be buyers to reduce their risk in default. As a result an entire chain of buyers and sellers is established, creating a potential chain reaction through the industry in the event of default. Due to the lack of transparency, it also becomes virtually impossible to know who owns what until or unless the swaps settle. Even then, because they are private transactions there is very little publicly available information on the settlement. There is even less available regarding who may have traded the instruments between origination and settlement. Just imagine if a $300,000 home would be worth $3 million to strangers around the globe in the event of a fire. That's essentially the situation with CDS.

The fourth complication is that the risk/reward of credit default swaps is asymmetrical. What this means is that the cost of a CDS is limited to its purchase price but the payout in the event of default is substantially greater. Since it is possible to insure the same debt multiple times its actual value, the profit potential in the case of default becomes virtually unlimited. On the other hand, the seller of CDS provides limited profit but virtually unlimited risks. This encourages speculation to support default.

As a result of these four factors, there were virtually no constraints on the CDS market. This explains why Chairman Cox, GE CEO Immelt, George Soros, and virtually every informed observer agreed that the CDS market is so subject to manipulation.

The most insidious aspect of credit default swaps is that they are essentially self-fulfilling prophesies. The mechanism is simple. Strong buying interest is reflected in higher prices. In other words, the more demand there is for insurance, the higher the premiums. In turn, higher premiums suggest to the market that there must be a greater risk of default. Without ownership transparency, it becomes impossible to determine if the higher premiums are because of additional buying or greater risk. As a result, the market must conclude that the risk of default rose, which in turn leads to even higher CDS prices.

According to Floyd Norris in the New York Times:

> *"'That is the new template,' one hedge fund manager told me today. 'All you have to do is buy credit default swaps and spread rumors. No cost to borrow. No accountability.' In fact, if you buy the credit default swaps and drive up their price, you don't even have to spread rumors. Other investors may conclude that the market knows something, and start selling shares. If you were already short the stock, there is plenty of profit to be made even if you did pay too much for the credit default swaps."*[149]

George Soros put it this way:

> *"CDS came into existence as a way of providing insurance on bonds against default. Since they are tradable instruments, they become bear-market warrants for speculating on deteriorating conditions in a company or country. What makes them toxic is that such speculation can be self-validating."*[150]

James Batterman, CFA and Olu Sonola, CFA of Fitch Ratings Service conducted a study published in CFA Magazine. One of the major points:

> *"few would argue with the notion that, all else equal, distressed trading levels imply an increased risk of expected loss, and it is impossible for a risk manager or overseeing accountant or auditor to ignore the worry associated with a*

> *security that is trading at highly distressed levels, as evidenced by very low market prices and exceptionally wide spread levels."*[151]

One piece of evidence to show that credit default swaps can be used to target specific firms rather than accurately reflect risk was found in a Merrill Lynch research report in early March that noted:

> *"it was more costly to protect oneself from the possibility of a default by Berkshire Hathaway than one by Vietnam. And General Electric CDS prices outstripped those of Russia—a country that a dozen years ago actually did default on its foreign debt"*[152]

# Appendix B:
# Short Selling and Naked Short Selling

Leslie Boni, Ph.D., published an important paper in September 2005. This work was initiated in 2004 when she served as a visiting financial economist at the SEC. What she discovered in her work, based primarily on statistical analysis:

> *"Using a unique dataset of the entire cross-section of U.S. equities, we document the pervasiveness of delivery failures and provide evidence consistent with the hypothesis that market makers strategically fail to deliver shares when borrowing costs are high. We also document that many of the firms that allow others to fail to deliver to them are themselves responsible for fails-to-deliver in other stocks. Our findings suggest that many firms allow others to fail strategically simply because they are unwilling to earn a reputation for forcing delivery and hope to receive quid pro quo for their own strategic fails."*[153]

This is important because those who regularly short stocks (and many otherwise employed by or connected to short sellers including many in the media) have attempted to argue that there is no hard evidence that failed trade data was caused in any meaningful way by naked short selling. These arguments typically hinge on a false premise that is that a lack of enforcement actions against naked short selling indicates that such naked shorting does not occur. Dr. Boni's work, however, provides strong statistical evidence that naked shorting does in fact take place and is a major cause of failure to deliver. To date, this study has not been refuted in any way.

It should be noted that despite about 5,000 complaints about naked short selling from January 2007 to June 2008 made to the SEC, not one led to an enforcement action and only 123 were even forwarded for additional investigation according to an 18 March 2009 report filed by David Kotz, the SEC's inspector general. [154] Kotz stated that the reason was the manner in which the agency processes complaints, weeding out many potentially legitimate complaints, and purposely ignoring complaints on this topic for various reasons. This is a very different finding from the false assertion that a lack of enforcement indicates that naked shorting is not a real problem.

The report from the SEC Inspector General was openly argued by SEC management using a variety of excuses, including that the agency lacked the resources to follow up on complaints, that there was a debate among practicing professionals as to whether or not a problem existed (no clear consensus), and that some observers believe *"the threat is widely exaggerated."*[155] The Office of Inspector General strongly responded that *"the SEC has repeatedly recognized that naked short selling can depress stock prices and have harmful effects on the market."*[156] Finally, the argument that the lack of findings by Self Regulatory Organizations (SROs) of naked short selling is a highly questionable defense in light of Dr. Boni's very clear findings that the major market makers purposely ignore failures to deliver from other firms so that their own failures to deliver will remain overlooked.[157]

It is interesting to note that the infamous Bernie Madoff, accused last December by the SEC for running a Ponzi scheme, once was the Chairman of the National Association of Securities Dealers (NASD), one of the SROs. In addition, Madoff is credited as the principal author of an SEC rule that exempted market makers (such as Madoff's firm) from some short-selling restrictions. According to a 17 December 2008 Reuter's story *"The former NASDAQ Stock Market Chairman regularly made appearances at the SEC, serving on Agency advisory panels, where he was widely regarded as a sage markets expert ."*[158]

Perhaps Madoff's stature explains why credible allegations against Madoff were ignored for so long. *"SEC Chairman Christopher Cox…said he was 'deeply concerned' by the agency's apparent multiple failures to thoroughly investigate almost a decade of credible allegations of wrongdoing at Madoff's brokerage firm."*[159] Ironically, Madoff was quoted at an SEC Panel on Regulations in April 2004 as saying: *"You really have to start with the assumption that most of us in this industry really have their client's interests, you know, coming first. Not necessarily the firm's self interest."*[160]

**The Madoff situation proves three important things:**

1. Self Regulatory Organizations have the potential to be corrupted.
2. A lack of enforcement by the SEC does not indicate a lack of wrong doing.
3. Sometimes actions can prove self serving for market makers (including, perhaps, the Madoff exemption that removed some short selling restrictions).

Another argument that naked short selling isn't a serious issue has been centered on the concept that "forced buy in" provisions will curtail the naked short selling problem. Sadly, lax enforcement and loopholes prevent effectiveness. A study by Richard Evans of the Carroll School at Boston College, Christopher Geezy and David Musto from Wharton at the University of Pennsylvania, and Adam Reed from the Kenan-Flagler School at the University of North Carolina was titled *"Failure is an Option: Impediments to Short Selling and Options Pricing."* The abstract of this report states:

> *"Regulations allow market makers to short sell without borrowing stock, and the transactions of a major options market maker show that in most hard-to-borrow situations, it chooses not to borrow and instead fails to deliver stock to its buyers."*[161]

Just for clarity, any stock can be "hard to borrow" if all available shares to borrow have already been sold short. This means that in a massive bear raid, market makers can and will go naked short.

One of the more interesting findings is that in a two-year study of a market maker, *"86 of the 69,063 failing positions, or 0.12% were bought in over the 2-year period."* In other words, there was very little effort to force buy-in on failures to deliver.[162]

The SEC finally recognized these vulnerabilities in 2003 and 2004 and thus implemented Regulation SHO, designed to curtail naked shorting. Dr. Boni documents this intention in her paper:

> *"On July 28, 2004, the Securities and Exchange Commission ("SEC") adopted Regulation SHO to modify rules for short sales in U.S. Equity markets. The adopting released states that one objective is to restrict 'naked' short selling, which 'generally refers to selling short without having borrowed the securities to make delivery.' Toward that objective, Rule 203 of Regulation SHO imposes new borrowing and delivery requirements on short sellers…"*[163]

Regulation SHO became effective on September 7, 2004, and compliance with the regulation began on January 3, 2005. Unfortunately, the regulation proved ineffective, due in part to a variety of exemptions provided to market makers (including the Madoff Exemption). The incidence of failed delivery did not diminish, in fact it grew substantially. In the year before the rule was enacted (ending December 2004), fails to deliver according to the DTCC averaged $3,418,010,542 on a daily basis. For the year 2007, the average daily fail rate had risen to $6,650,684,997. In the first quarter of 2008, the rate rose further to $7,567,755,627, or more than double the rate BEFORE the rule was enacted.[164]

This should not be considered surprising in light of the thoughts from Susanne Trimbath, Ph.D. who said in a letter to Investment News:

> *"The most important part of the 'naked shorting' problem is that broker-dealers are allowed to fail to deliver shares at settlement….Regardless of any amendments to SEC Regulation SHO, until something is done to strictly enforce settlement, this problem will persist. Ignoring the source of the problem is no way to find a solution."*[165]

Dr. Trimbath has the education, training, and experience to understand the issue in detail. She is a former manager of depository trust and clearing corporation in San Francisco and New York and a senior adviser on a capital markets project to create trade clearing and settlement in Russia. She holds a Ph.D. in economics from New York University.[166]

On August 29, 2006, Dr. Trimbath wrote a 14-page letter to the SEC, urging enforcement of naked short sale rules by demanding settlement of all failures to deliver. She makes an articulate case, describing how fails to deliver *"disrupt market efficiency"* and cheats investors *"of ownership rights and privileges."* She points out that due to naked shorting, many investors may not have their votes counted because the number of votes exceeds the number of legally authorized shares.[167]

Dr. Trimbath also effectively articulates the fact (by the SEC's own admission) *"that not only do the broker-dealers not know whose shares are bought, sold and lent, they can't even tell if a selling customer has delivered shares. I am highly confident that they can* *keep track of whose money has been received; there is no excuse for not extending the same level of fiduciary care and diligence to the securities side of transactions."*[168]

In light of this, as well as the SEC's long-standing policy of not requiring public disclosure of naked short sale data, it is ironic that the Commission would decry the lack of data-driven study showing the harms of naked short selling as reason to not take action. Beyond that, the data that the SEC and DTCC have released in attempts to deny a short selling problem have been called statistical poor at best and outright misleading at worst. Here are Dr. Trimbath's comments on this subject:

> *"The Commission specifically asks commenters to 'provide analysis and data to support their views.' This is exceedingly difficult to do since the DTCC is obfuscating the real magnitude of the problem by using poor metrics and biased statistics. For example, in footnote 3 (p.3) of the file there are NSCC statistics on average daily failures to settle as a percentage of the dollar value. It is deceptive to use a figure based on a dollar value to support the statement that 'the majority of trades settle on time' because a statistic describing the majority of 'trades' should be by number, not by value.*
>
> *Again, in footnote 18 (p.8), the Commission offers NSCC statistics from two unequal time periods to support the statement 'that Regulation SHO appears to be significantly reducing fails to deliver.' Data from the 9 months from April 1, 2004 to December 31, 2004 are compared to the 17 months from January 1, 2005 to May 31, 2006. Comparing statistics from periods of different lengths is bad math, at best. Furthermore, it is well known that market data exhibit seasonal variation. It is particularly deceptive to include January in one and not the other since the 'January effect' is especially well-known and studied."*[169]

Issues such as these raise reasonable suspicion regarding why the practice of naked short selling and other failures to deliver shares have been allowed to persist. As with credit default swaps, there is a clear lack of transparency with naked short selling.

It is clear that the existence of naked shorting is undeniable. One spectacular case took place in February 2005, after the SHO regulations were put in place to curb naked shorting. According to a 25 August 2006 story in Forbes:

> *"Suspicious trading last year in shares of* ***Global Links****, a small Nevada real estate holding company, was far more intense than previously thought. New data from the U.S. Securities and Exchange Commission reveals trade settlement fails in early February 2005 that were 27 times greater than the total number of shares Global Links had issued at the time. The data show suspicious trading in Global Links far earlier and to a far larger degree than any previously released by the SEC. The data was obtained this week by a Freedom of Information Act request…"*[170]

What is so startling about this case is that one individual, Robert Simpson, bought 100% of the existing outstanding shares and all failed to deliver. In fact, he bought 126,986 shares more than the 1,158,064 shares that were officially issued at the time. Mr. Simpson filed with the SEC as 100% owner of Global Links. Then, over the next two trading days approximately 60 million shares changed hands even though Mr. Simpson did not trade a single share.[171]

While it is clear that Global Links was a penny stock that could be claimed to be of dubious value, the real question has to do with the problems of the system that could allow such clear manipulation. A further reasonable question asks why the SEC was not at the forefront of enforcing rules even in regard to a penny stock. Not only has enforcement been lacking but also simple investigation of naked shorting complaints.

To be certain, there are a number who defend the practice of naked short selling, including hedge funds, law firms that support short sellers, and sometimes even the regulators themselves. One such defense was provided in a paper titles *"Naked Shorting,"* published on 26 April 2007, by Christopher Culp of Lexicon, Inc. and J.B. Heaton of Bartlit Beck Herman Palenchar & Scott LLP.[172] The paper was quoted extensively in a 19 March 2009 article in the Business Insider written by John Carney, *Naked Shorting Doesn't Matter*. Carney opens his article with the following:

> *"The news that almost 33 million shares (of) Lehman Brothers were sold and not delivered to buyers on time in the days before its bankruptcy is sure to revive the old theories that somehow naked short sellers manipulated the price of the stock through the practice of 'naked shorting.' It shouldn't. Naked shorting—selling a stock without first borrowing it—has almost no effect on the price of a stock."*[173]

Carney's statement, however, is basically disproven by the very paper he posts to support his conclusions. From page 23 of the report from Culp and Heaton:

> *"Naked short selling is likely to affect the market for sellers of securities by lowering the market clearing price through an artificial increase in the quantity of shares."*[174]

The argument that Culp and Heaton go on to make, however, is very different from Carney's assertion that naked short selling *"has almost no effect on the price of a stock."*[175] Instead, these authors argue that naked shorting does impact the price of stocks but only in the same manner as traditional short selling, which is presumably okay for the market because the added liquidity offsets the short-term dislocations.

Most academics and real-world participants agree that traditional short selling can be beneficial and that the benefits may outweigh the costs. But the argument that naked short selling is economically equivalent to selling of legally borrowed stock is highly flawed for a variety of reasons. For one, it violates the principle of one vs. many. In isolation, a naked short sale of a single share of stock does function very much like a traditional short sale. Instead of borrowing a share of stock from a current holder, the naked short seller in effect borrows from the buyer of the share he sold. The obligation to repay thus remains. In the event that many shares are sold short, however, there is a serious difference. With traditional short selling, there is a constraint on the number of shares that may be sold, only as many as may be borrowed. This in turn is limited by the number of shares available in the public float which is based ultimately on the number that have been issued. This is clearly a finite number.

With a naked short sale, however, the presumed limit of shares to be sold short has absolutely nothing to do with the availability to borrow. In fact, naked short sales, by definition, occur when there are no shares to borrow. Neither the public float nor the number of issued and outstanding shares provides a limit. Instead, the limit essentially becomes the amount of capital the short seller has to put up against the short position. Fortunately, for the short seller, the capital requirements actually diminish as the price of the stock falls, even if in response to the short sale itself. Thus, an unlimited amount of capital can create an unlimited amount of shares short and thus drive the price lower through the simple supply/demand equation.

Another anecdotal example of a large number of created shares through naked short selling can be seen in the stock of TASER. A RICO-based lawsuit was reported about in Law.com. A key basis for the complaint:

> *"'Objective shareholder voting data demonstrates that the defendants' unlawful selling of unregistered and unissued TASER shares flooded the market with counterfeit shares' it says. 'For example, at the time of TASER's 2005 annual vote, TASER had approximately 61.1 million shares outstanding. Yet approximately 82 million shares voted, an additional over-vote of approximately 20 million shares.'*
>
> *That figure is 'particularly compelling,' said the complaint, because the day of the vote there were roughly 17.2 million shorted shares of TASER stock. Thus, '(e)ven if all of the TASER shares that were sold short were able to vote…there were at least 3.7 million shares that were undoubtedly counterfeit.''"*[176]

These are known as over votes.

What makes this more amazing is the fact that, according to a Bob Drummond article, many legitimate shareholders simply don't vote in corporate elections. This means that votes from short selling are likely much greater than recognized:

> *"The arrival of millions of duplicate ballots in a corporate election would be more obvious if not for one fact: In many elections, up to half of all stockholders don't participate…*
>
> *'It's invisible,' says Paul Schulman, executive managing director of Altman Group Inc., a proxy solicitor based in Lyndhurst, New Jersey. 'Most of the time you don't get overvotes because so many shareholders don't vote.''*[177]

When investigated, however, there is substantial evidence that over-votes are increasingly impacting elections, even if participation by traditional shareholders remains low. In 2005, for example, the Securities Transfer Association reviewed 341 shareholder votes finding evidence of over voting in every single case.[178]

As in the case of TASER, the pervasiveness of over votes suggests that a large number of shares have been sold short in a large number of companies. So, while the economic effect of an isolated naked short sale may be minimal, broad-based naked short sales will have a wide impact, including by influencing corporate elections. This is an incremental harm rarely discussed by defenders of naked shorting.

# Appendix C:
# The Uptick Rule

There has been a fierce debate in academic circles regarding the effectiveness of the uptick rule in curbing bear raids. Opponents of the rule point to a six-month SEC study conducted based on a pilot program that took place in 2005, comparing 943 randomly selected stocks from the Russell 3000 (a broad-based index of US stocks) to the remaining 2,067 in the index. The 943 were not subject to the uptick rule. Over the six months, the SEC found that the stocks not subject to the uptick rule had 2% lower returns than those subject to the rule, an amount that they considered to be statistically irrelevant. Proponents for the rule believe that the study used to justify rescission had several key flaws. These were summarized in a November 18, 2008 Wall Street Journal Op-Ed by Robert Pozen and Yaneer Bar-Yam titled, *There's a Better Way to Prevent 'Bear Raids,' The SEC should restore the uptick rule*.[179] [Pozen is chairman of MFS Investment Management and Bar-Yam is president of the New England Complex Systems Institute.] Their argument in favor of restoring the rule included the following thoughts regarding the study:

1. It took place over six months, a particularly short period to study a 70-year rule.
2. It took place during one of the calmest market periods of recent history.
3. The 2% price differential is meaningful given the fact that historic annual price returns for U.S. stocks are in the 6-7% range.
4. That proper statistical analysis would have adjusted for outliers and thus made the 2% differential statistically significant.
5. That anecdotally there *"was a marked increase in the number of NYSE-listed stocks with price drops of over 40% in a day –a rough proxy for a bear raid."* By comparison, the 12 months following the 2007 market peak (after the uptick rule was eliminated) had roughly twice as many stocks drop 40% in a day than the 12 months after the market peaked in 2000 (when the uptick rule was in place). Yet the period overall had similar market declines and high volatility.[180]

The New York Stock Exchange conducted a survey of 438 CEOs, CFOs, and investor relations executives in October 2008. Of those surveyed, 85% favored restoring the uptick rule and 82% believed it would instill investor confidence.[181]

In response, the SEC has been studying the issue and intends to put some restrictions back in place according to current chairman Mary Schapiro. At present there are five alternative proposals under consideration. Regardless, a large number of market experts believe that the elimination of the uptick rule added to the potential for bear raids.[182]

# Appendix D:
# Double- and Triple-Short ETFs

In June 2006, ProShares ("the world's largest provider of short and leveraged funds") launched the first major short-selling Exchange Traded Fund (ETF) known at the ProShares Short Fund. What it provided was a simple way for traders and investors to hedge or go short a major market index such as the Dow Jones Industrial Average or S&P 500. [183]This was a significant development because it created a new security that was easily bought or sold that provided short exposure set to benefit from a decline in an index.

ETFs represent a basket of stocks held to mirror an index or represent a specific industry or geography. The mechanics of ETFs are such that the mangers of them are forced to square trades at the end of each trading session. In the case of a short ETF, the manager will sell short stocks at the end of a trading day to match exposure for the fund with investments in the fund. Thus, if the short fund has $100 million of capital, it needs to have $100 million of shares sold short. The bottom line is that short ETFs made it substantially easier to sell stocks short for both institutional and individual investors.

The nature of ETFs is to provide liquidity. This requires designated market makers ready to provide that liquidity as needed. Given the market maker exemption, this basically means that short ETFs will be allowed to naked short sell (through market makers) to meet investor demands. This was a significant development which added vulnerability to the system.

From inception through June 2007, ProShares garnered nearly $6 billion in assets. Then, coinciding with the elimination of the uptick rule, ProShares introduced their line of double-short ETFs. These are two-times levered short funds known as UltraShort. Their purpose is to inversely mimic market movements on a daily basis with a factor of two. So, if an index were to drop 5% in a day, the UltraShort's goal would be to show a 10% gain for that day. This was a momentous development and likely exacerbated the market drop.[184]

The mechanics are simple. Double-Short ETFs use swaps, options, derivatives, and other instruments to mimic short selling on a leveraged basis. Then, at the end of the trading day, the managers reallocate portfolios to match the exposure in the real market. If an investor buys a $10,000 position in the UltraShort, the fund will need $20,000 of short exposure. If the market drops 10%, the investor's stake should rise in value by 20% to $12,000. To be in line with a double short mandate, the fund should have $24,000 of short exposure. But, since the market fell 10%, the actual short exposure of the fund will only be $18,000. To get back in line, the fund must sell short an additional $6,000 worth of stock. This squaring up takes place in the final hour of the trading day, greatly adding to the volatility.[185]

# Appendix E:
# Was the Short-Selling Ban on Financials Effective?

On 17-18 September 2008, the SEC issued several temporary emergency orders restricting and in cases outright banning short sales. These orders banned short selling in 799 financial firms, restricted naked short selling, and declared attempts to deceive regarding naked short selling as manipulative acts. These actions were undertaken in an attempt to restore some level of confidence to the markets.[186]

When evaluating the effectiveness of these restrictions, it should be noted that during the outright ban, which ended after one extension on 9 October 2008, the S&P 500 declined 17.8%.[187] That factor has been cited as proof that the ban was ineffective. Proponents for short selling also declare that this is proof that short selling was not the cause of the market turmoil. The following factors must be considered, however:

1) Only 799 financial firms were included in the outright ban. These shares declined an average 12.8%, far less than the 17.8% for the market as a whole. So, the ban likely had some beneficial effect, at least on a relative basis.[188]
2) Even with the ban, data from the SEC, the NYSE, and Bloomberg shows that *"The ban, which lasted through Oct 17, didn't eliminate shorting…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 selling averaged 37.5 percent of the overall trading on the exchange in the three companies."*[189]
3) The ban was implemented after the initial triggering event. Thus, the most serious short selling may had already taken place and previously established positions were allowed to remain in place.
4) Continued market declines after the short-selling ban was put in place likely included concerns of coming economic weakness that would be caused by the near collapse of the credit markets.
5) The penalties of the ban were notably weak and vague. In the case of naked short sales, the penalty was a prohibition against further naked short sales.
6) There was little mechanism to oversee compliance other than via an audit. Unfortunately, the audit process is a long and complex one and would occur far after the fact, complicated greatly by the lack of transparency.
7) The ban did nothing to slow or stop day-trading oriented bear raids. If the position was covered in the delivery time frame (within three days of the trade), there would be no way to tell if the sale was a naked short sale or not. The nature of the bear raids conducted in mid September was characterized by rapid bear raids wherein trades were open for three days or less.
8) The outright but temporary ban on legitimate (non-naked) short selling had the unintended consequence of reducing liquidity and preventing natural hedging. This caused major hedge funds to liquidate existing long positions, producing downward pressure on stock prices and exacerbating the market decline.

9) The short-selling ban did nothing to stop the use of Credit Default Swaps in continuing the bear raids.

# Appendix F:
# Hedge Funds Ranked by Earnings in 2008

| Rank | Name | Firm Name | 2008 Earnings |
|---|---|---|---|
| 1 | **James Simons** | Renaissance Technologies Corp. | $2.5 billion |
| 2 | **John Paulson** | Paulson & Co. | $2 billion |
| 3 | **John Arnold** | Centaurus Energy | $1.5 billion |
| 4 | **George Soros** | Soros Fund Management | $1.1 billion |
| 5 | **Raymond Dalio** | Bridgewater Associates | $780 million |
| 6 | **Bruce Kovner** | Caxton Associates | $640 million |
| 7 | **David Shaw** | D.E. Shaw & Co. | $275 million |
| 8 | **Stanley Druckenmiller** | Duquesne Capital Management | $260 million |
| 9 (tie) | **David Harding** | Winton Capital Management | $250 million |
| 9 (tie) | **Alan Howard** | Brevan Howard Asset Management | $250 million |
| 9 (tie) | **John Taylor Jr.** | FX Concepts | $250 million |
| 12 | **James Chanos** | Kynikos Associates | $225 million |
| 13 | **Michael Platt** | BlueCrest Capital Management | $210 million |
| 14 | **Roy Niederhoffer** | R.G. Niederhoffer Capital Management | $200 million |
| 15 | **John Horseman** | Horseman Capital Management | $180 million |
| 16 | **Paul Touradji** | Touradji Capital Management | $140 million |
| 17 | **Henry Laufer** | Renaissance Technologies Corp. | $125 million |
| 18 | **Kenneth Tropin** | Graham Capital Management | $120 million |
| 19 (tie) | **Pierre Andurand**<br>**Dennis Crema** | BlueGold Capital Management | $90 million |
| 19 (tie) | **Christopher Rokos** | Brevan Howard Asset Management | $90 million |
| 22 (tie) | **Christian Baha** | Superfund | $85 million |
| 22 (tie) | **Christian Levett** | Clive Capital | $85 million |
| 24 | **William Dunn** | Dunn Capital Management | $80 million |
| 25 | **Andrew Hoine** | Paulson & Co. | $75 million |

Source:  *Alpha Magazine*, April 2009 [190]

# Appendix G:
# Concerns Regarding Shariah Compliant Finance

The concerns regarding Shariah Compliant Finance stem from four key areas:

1) The origins of the Shariah Finance Movement,
2) The lack of transparency in Shariah Finance,
3) The ties of those sponsoring and creating SCF, and
4) The mandatory giving required.

The first area has to do with the origins of the movement. Many believe that these can be directly traced to the founder of the Muslim Brotherhood in the 1930s. A historical overview can be found in ***The Fifth Generation Warfare (5GW) Shari`ah Financing and the Coming Ummah*** *written by Rachel Ehrenfeld and Alyssa A. Lappen:*

> *"The origins of the modern financial jihad infrastructure, including all Islamic economic and financial regulatory organizations like the 1991-Bahrain-registered and -based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), date back to the 1920s and were an invention of Muslim Brotherhood (MB) founder Hassan al Banna. He designed political, economic, and financial foundations to enable Muslims to fulfill a key form of jihad mandated by the Qur'an – financial jihad. He viewed finance as a critical weapon to undermine the infidels – and "work towards establishing an Islamic rule on earth." He was first to understand that to achieve world domination, Muslims needed an independent Islamic financial system to parallel and later supersede the Western economy. Al-Banna's contemporaries and successors (such as the late Sayed Qutb and current Yusuf al-Qaradawi) set his theories and practices into motion, developing shari`ah-based terminology and mechanisms to advance the financial jihad – "Islamic economics", finance, and banking.*
>
> *Early 1930s MB attempts to establish Islamic banking in India failed. Egyptian president Gamal Abdel Nasser shut down the second attempt, in 1964, after only one year, later arresting and expelling the Muslim Brotherhood for attempts to kill him. But Saudi Arabia welcomed this new wave of Egyptian dissidents, as did King Saud bin Abdel Aziz earlier waves in 1954 and 1961. Their ideas so appealed to him and his clerics that in 1961, Saud funded the MB's establishment of the Islamic University in Medina to proselytize its fundamentalist Islamic ideology, especially to foreign students. In 1962, the MB convinced the king to launch a global financial joint venture, which became the cornerstone and engine to spread Islam worldwide."*[191]

What is so concerning to some is that the stated purpose of the founding of SCF was jihad as defined by the Muslim Brotherhood. As a result, many believe that its very nature is to promote jihad in all forms.

The second serious issue with SCF has to do with its lack of transparency. David Yerushalmi, Esq. discussed this issue at length in his paper, *Shari'ah's Black Box: Civil Liability and Criminal Exposure Surrounding Shari'ah-Compliant Finance:*

> *"First, and most troubling, is the Shari'ah "black box" syndrome: U.S. financial institutions and businesses involved in SCF risk grave consequences by willfully ignoring the endogenous elements of Shari'ah. Ignoring what Shari'ah is -- both in theory and in practice -- and its intimate connection to Islamic terror and holy war against the non-Muslim world amounts to corporate recklessness. Moreover, placing Shari'ah in a black box and treating its prohibitions as if they were benign secular and objective "screens" ignores the duty of disclosure of the most important elements of Shari'ah: its purposes and its ultimate methods."*[192]

Basically, because the investment selections are made for religious and traditional rather than economic reasons, Shariah Compliant Finance is much more complicated than simply avoiding objectionable investments as with traditional Socially Responsible Funds. Yerushalmi goes into great detail in demonstrating that the investment profit motive is a far distant second to achieving jihad aims. Yet, most of this is hidden so that the actual investment approach remains virtually unknown. This lack of transparency could also allow money-laundering. Because the SCF programs attempt to incorporate as much Islamic tradition as possible, they often involve an informal funds transfer system based on trust known as hawala. In these cases there may not be any paper trail, running the risk of money laundering and other problems.

One of the prime examples of concern regarding a lack of transparency and potential corruption can be seen in the Iranian Shariah Finance movement according to a *Forbes* magazine report:

> *"The other side of Iran's economy belongs to the Islamic foundations, which account for 10% to 20% of the nation's GDP--$115 billion last year. Known as bonyads, the best-known of these outfits were established from seized property and enterprises by order of Ayatollah Khomeini in the first weeks of his regime. Their mission was to redistribute to the impoverished masses the "illegitimate" wealth accumulated before the revolution by "apostates" and "blood-sucking capitalists." And, for a decade or so, the foundations shelled out money to build low-income housing and health clinics. But since Khomeini's death in 1989 they have increasingly forsaken their social welfare functions for straightforward commercial activities.*
>
> *Until recently they were exempt from taxes, import duties and most government regulation. They had access to subsidized foreign currency and low-interest loans from state-owned banks. And they were not accountable to the Central Bank, the Ministry of Finance or any other government institution. Formally, they are under the jurisdiction of the Supreme Leader; effectively, they operate without any oversight, answerable only to Allah.*

> *According to Shiite Muslim tradition, devout businessmen are expected to donate 20% of profits to their local mosques, which use the money to help the poor. By contrast, many bonyads seem like rackets, extorting money from entrepreneurs. Besides the biggest national outfits, almost every Iranian town has its own bonyad, affiliated with local mullahs. 'Many small businessmen complain that as soon as you start to make some money, the leading mullah will come to you and ask for a contribution to his local charity,' says an opposition economist, who declines to give his name. 'If you refuse, you will be accused of not being a good Muslim. Some witnesses will turn up to testify that they heard you insult the Prophet Mohammad, and you will be thrown in jail.'"*[193]

[In a very sad note, the author of this expose was found murdered in Moscow less than a year after publishing his report. His work was primarily directed toward Russian organized crime but saw a possible intersection with Iranian Shariah Finance, prompting his investigation there. At the time of his death in 2004, Paul Klebnikov was the only American reporter killed in Moscow.][194]

The third issue has to do with concerns regarding those currently promoting SCF. The Shariah scholars are considered "rock stars" in the industry and can generate as much as $50,000 per year in fees from as many as 20 or 25 different Shariah boards. Yet, these individuals are not placed in their positions because they are experts in economics or finance. Instead, they are specifically chosen because of their training in Shariah. According to Dr. Patrick Sookhdeo:

> *"The main institutions issuing fatwas on financial matters are the Fiqh Academy in Jedda, Saudi Arabia, affiliated to the Organization of the Islamic Conference (OIC), the European Council for Fatwa and Research and the Fatwa Council of North America. These institutions are connected to the Islmist Wahhabi, Salafi, Muslim Brotherhood, and Deobandi movements."*[195]
>
> *"In this fashion, SCF institutions are underwriting—and thereby enabling—some of the worst Jihadists in the world. Very few of them have any credentials in economics or finance. Most have been educated in the madrassas and Shariah studies programs of Saudi Arabia, Pakistan, Malaysia or Egypt's Al Azhar University. Naturally, these SCF authorities are adherents to Shariah and, therefore, seek to transform America—and, indeed, the world—into an Islamic state."*[196]

A 3 April 2008 article written by Alex Alexiev provides an example that explains the concern. [Alexiev is vice president for research at the Center for Security Policy.]:

> *"Consider the board chairman of the Dow Jones Islamic Index (IMANX), one Mufti Taqi Usmani. Mr. Usmani is widely reputed to be one of the world's top experts on sharia finance. Whatever his stockpicking abilities may be, they are dwarfed by his jihadist credentials. A key executive of Pakistan's prominent Deobandi jihadist factory, the madrassa Darul Karoom Karachi (currently*

> *headed by his brother, Rafi Usmani), Taqi Usmani has openly advocated jihad by Muslims in the West, and just last month again publicly endorsed suicide bombing and the Taliban."*[197]

The fourth issue has to do with the concept that Shariah finance ultimately sponsors terror organizations. According to the U.S. Naval War College publication, this is not an unfortunate side-effect but rather an intended purpose from the beginning:

> *This venture created charitable foundations, which the MB oversees and from which most Islamic terrorist groups benefit. The first were the Muslim World League (MWL) and Rabitta al-Alam al-Islami, uniting Islamic radicals from 22 nations and spinning a web of many other charities with hundreds of offices worldwide.15 In 1978, the kingdom backed another MB initiative, the International Islamic Relief Organization (IIRO), which, with all these 'charities,' is implicated for funding al Qaeda, the 9/11 attacks, Hamas, and others.16 These 'charities' are used to advance the Muslim Brotherhood and Saudi political agenda, namely empowering the ummah and imposing worldwide shari`ah. 'I don't like this word 'donations',' al-Qaradawi told BBC Panorama on 30 July 2006. 'I like to call it Jihad with money, because God has ordered us to fight enemies with our lives and our money.'"*[198]

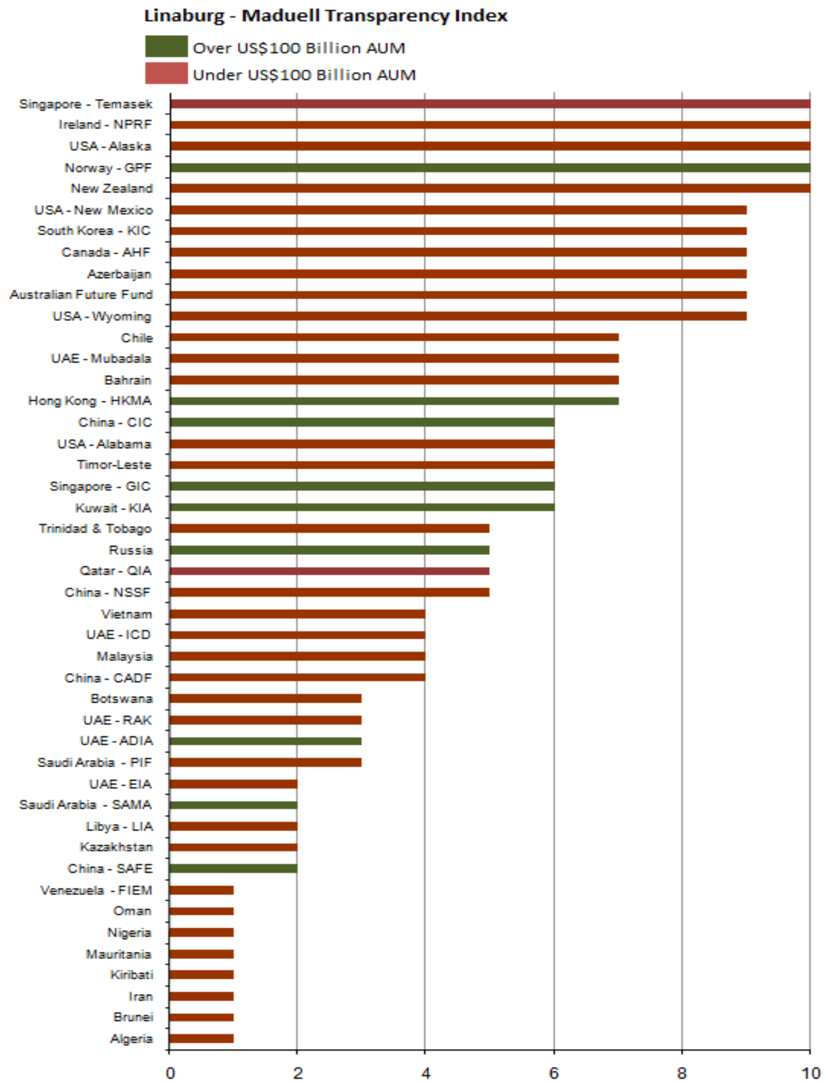
The cumulative impact of these mandatory donations can be enormous. According to Dr. Patrick Sookhdeo:

> *"Studies in recent years describe how the largest single source of funds for Islamic terrorism is zakat (the obligatory charitable donation for Muslims) which typically goes through the Islamic banking system."*[199]

The issue is that the obligatory contributions must be directed to Imam-approved charities. Yet, the process of determining the acceptability of these charities is clouded in secrecy. And, serious suspicions have been raised about the Imams based on public statements made regarding jihad.

It is highly likely that many who participate in SCF do so with the simple motive of following their personal religious traditions. They might well be aghast to learn about the more radicalized jihad intentions hidden in the movement. The point is not to say that all involved in SCF have ill motives. The point is that SCF provides a financial mechanism for those with ill motives to pursue radical jihad. Sadly, the lack of transparency makes it impossible to separate the factions by motive.

# Appendix H:
# Linaburg-Maduell Transparency Index 4th Quarter 2008




Source: Linaburg and Maduell, Sovereign Wealth Fund Institute, http://www.swfinstitute.org/research/4q2008transparency.php[200]

| Point | Principles of the Linaburg-Maduell Transparency Index |
|---|---|
| +1 | Fund provides history including reason for creation, origins of wealth, and government ownership structure |
| +1 | Fund provides up-to-date independently audited annual reports |
| +1 | Fund provides ownership percentage of company holdings, and geographic locations of holdings |
| +1 | Fund provides total portfolio market value, returns, and management compensation |
| +1 | Fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines |
| +1 | Fund provides clear strategies and objectives |
| +1 | If applicable, the fund clearly identifies subsidiaries and contact information |
| +1 | If applicable, the fund identifies external managers |
| +1 | Fund manages its own web site |
| +1 | Fund provides main office location address and contact information such as telephone and fax |

# Appendix I:
# Critical Assumptions Contained in this Report

The following are thirty-five numbered assumptions that undergird the analysis of this report. In each case, there is substantial supporting evidence underneath the assumptions as shown in the report and endnotes. Nevertheless, to allow critical analysis, these assumptions are identified and numbered with a notation to the corresponding page number in which the assumption is indicated. There are also several endnotes provided in this section, representing additional supporting data or supporting opinions for the assumption listed. This is in addition to the research already present in the report and was located after the completion of the main body of work.

These assumptions are listed in the order that they appear in the report, creating some redundancy in the pursuit of completeness.

1. That the oil price spike in late 2007 and early 2008 could have been caused in part by speculation rather than simple market supply/demand factors (pp. 8-9).

   **[It should be noted that this position was recently supported by concerns from U.K. Prime Minister Gordon Brown, French President Nicolas Sarkozy and the head of the Commodity Futures Trading Commission.** [201] **Brown and Sarkozy wrote an Op-Ed identifying that speculation was at work and acknowledging that it threatened the global economy. Their comments:**

   > ***"…erratic price movement in one of the world's most crucial commodities (oil) is a growing cause for alarm. The surge in prices last year gravely damaged the global economy and contributed to the downturn… We therefore call upon the International Organization of Securities Regulators to consider improving transparency and supervision of the oil futures markets to reduce damaging speculation…*** [202] **]**

2. That the collapse of Bear Stearns hindered investor confidence (p. 10).

3. That the prospective collapse of Fannie Mae and Freddie Mac threatened the U.S. economy (p.11).

4. That the housing market was a bubble, and combined with high levels of leverage and an outdated regulatory structure created vulnerability in the financial system (pp. 7, 11-13).

5. That some oil producing states and other groups within oil producing areas view oil as a potential economic weapon (pp. 15-18).

6. That the global energy markets may be subject to manipulation (pp 16-17, 20-23).

   **[Commodity Futures Trading Commission Chairman Gary Gensler has acknowledged the possibility that speculation was a major force behind the ramp in oil prices and has proposed public commentary as a first step in possible regulation.[203] This is a significant departure from the former CFTC's official stance last July near the oil price peak.[204] In light of market activity in the second half of 2008, the CFTC now acknowledges the possibility that speculation was a major factor.]**

7. That Sovereign Wealth Funds are complex investors with possible geo-political motives in addition to economic motives (pp. 18-19).

   **[Former Treasury Secretary and current Obama advisor Larry Summers made this argument in a 29 July 2007 Financial Times editorial. In it, Summers states:**

   > ***"What has received less attention are the particular risks associated with ownership by government-controlled entities, particularly ... direct investments. The logic of the capitalist system depends on shareholders causing companies to ... maximise the value of their shares. It is far from obvious that this will ... be the only motivation of governments as shareholders. They may want to see their national companies compete effectively, or to extract technology or to achieve influence."[205]*]**

8. That "bear raids" (defined as the targeting of specific companies, industries, or markets with the purpose of lowering their price through concerted trading activity such as short selling or the use of derivatives, possible rumor spreading, and other activity to encourage selling) do in fact take place (pp.23-24).

9. That unregulated credit default swaps could be manipulated and thus undermine investor confidence in targeted companies. High CDS rates equal decreased investor confidence (ceteris paribus).

   **[Treasury Secretary Timothy Geithner essentially acknowledged as much in his recent testimony before Congress. He stated clearly that the CDS market had no transparency and was so large that it "blindsided the government." In his testimony he referenced the risk of manipulation and lobbied for additional regulatory authority to counter that risk.[206] It is fair to state that the official Administration position is to acknowledge that the CDS market has been unregulated, has been vulnerable to manipulation, and is of sufficient size to create a systemic economic vulnerability. These thoughts were echoed by SEC Chairman Mary Shapiro.[207]]**

10. That Credit Default Swaps offer an asymmetric risk/reward pattern (p. 27).

**[This is essential to understand because it suggests that buying Credit Default Swaps is a means to be short the credit of a particular creditor with a payout in the case of a default. The risk is limited to the price of the CDS but the reward was many times greater in the case of default. On the other side of the trade, the seller of CDS had a limited reward but almost unlimited risk. Firms such as AIG were willing to sell large quantities of CDS under the belief that they were overpriced. But, excessive buying combined with an asymmetric risk/reward pattern could create a self-fulfilling prophecy, destroying the credit worthiness of a borrower simply because of high CDS rates. This position is supported by recent comments from noted Hedge Fund manager, George Soros.[208]]**

11. That naked short selling (selling shares of stock neither owned nor borrowed as evidenced by a failure to deliver the sold shares to the buyer in the prescribed time period) can impact the price of a stock (pp. 28-30).

12. That double-short and triple-short ETFs contributed to the selling pressure and also allowed an additional layer of confidentiality to short sellers (pp. 31-32).

13. That a combination of bear raids targeted to specific financial services companies could undermine credit availability, impact investor confidence, and create accredit shortage that would affect the overall economy.

14. That a decrease in credit availability combined with lower investor confidence and decreased asset prices results in impaired economic activity, creating something of a downward spiral.

    **[This view is supported not only by logic but also recent economic research conducted by Citigroup.[209]]**

15. That there has been a serious lack of transparency in regard to hedge fund ownership and activity (pp. 35-36).

    **[This view has become the official position of the Obama Administration which has called for new regulations requiring transparency.[210]]**

16. That the lack of transparency extends to and has been magnified by Credit Default Swaps, naked short selling, dark pools, and sponsored access trading (pp. 36-39).

17. That globalized financial markets can provide access to foreign entities, including unfriendly regimes and terror organizations, especially when transparency is lacking (pp. 40-41).

18. That the lack of transparency makes the determination of motive and purpose of trading activity difficult to assess (pp. 40-41).

19. That a sudden, sharp increase in trading activity by two previously smaller firms raises red flags to be considered (pp. 41-42).

20. That some market participants may have non-economic motives behind their trading activity (pp. 43-44).

21. That some hedge funds may provide (with or without their knowledge) vehicles through which non-transparent investments by various parties with various motivations (pp. 45-47).

22. That criminal elements and /or terror organizations can access U.S. capital markets (pp. 47-48).

23. That radical Islam elements desire to topple the U.S. financial system and economy (pp. 49-50).

24. That radical socialist elements desire to see the elimination of capitalism (pp. 51-52).

25. That some of those who practice Shariah Compliant Finance (SCF) view its intended destiny as replacing Western finance and capitalism (pp. 52-54, 55).

26. That there are substantive ties between Shariah Compliant Finance and Sovereign Wealth Funds (pp. 54-56).

27. That Sovereign Wealth Funds have meaningful access to capital markets and sufficient capital to impact them (pp. 56-57).

28. That Sovereign Wealth Funds have the capacity and ability to sell short or otherwise benefit from the declining value of assets (pp. 57-59).

29. That a lack of transparency has enabled Sovereign Wealth Fund activity to enter U.S. capital markets with little or no awareness as to source if accomplished via feeder funds and offshore hedge funds (p. 61).

30. That a number of other well-capitalized global players have gained access to U.S. capital markets and could be viewed as having motive, means, and opportunity to interfere in the U.S. economy for various purposes. These players could include nation states (or elements within them) such as Iran, Venezuela, Russia, North Korea, and China as well as groups such as the Taliban and al Qaeda (pp. 62-63).

31. That economic sabotage and warfare does take place and may be evidenced by money laundering, counterfeiting, and espionage (pp. 63-65).

32. That the severity of the crisis has placed the U.S. economy in a substantially more vulnerable position than previously, due in part to additional debt and projected future government deficits. This is viewed as a potentially unavoidable consequence of the crisis (pp. 66-67).

33. That an additional vulnerability may have been exposed in regard to the U.S. dollar's position as global reserve currency (pp. 68-69).

34. That a future purposed rejection of the dollar as reserve currency could create an unfavorable global economic imbalance and directly harm U.S. interests (pp.69).

35. That there may be a point in the possibly near future in which certain global actors may believe that the benefits of a severely weakened dollar would outweigh the short-term detriments. The motivation could be to change the global economic balance of power, to cripple the U.S. economy, or to inhibit the ability to fund the American military (pp. 69-73).

Overall, the belief is that there are a number of global market participants who had the motive, means, and opportunity to cause, trigger, or at least participate in the recent economic crisis. Further, this threat continues to exist today with a likely change of tactics and/or strategy going forward.

Finally, it should be noted that these assumptions do not form a dependent chain. It is very possible that even if one, several, or many of the considerations/assumptions were viewed as unlikely, a serious vulnerability would remain intact. A single exposed issue should demand further study at a minimum.

To put it quite simply, if even a small percentage of this paper's concerns are on target, a significant response is required.

# Endnotes

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