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What Happens in Vegas Doesn't Always Stay in Vegas: Nevada Corporations Enjoy a Disproportionate Share of SEC Trading Suspensions

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WHAT HAPPENS IN VEGAS DOESN'T ALWAYS STAY IN VEGAS: NEVADA CORPORATIONS ENJOY A DISPROPORTIONATE SHARE OF SEC TRADING SUSPENSIONS

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Other than Delaware, which is a huge “importer,” only Nevada has a significant net inflow of firms (Bebchuk and Cohen 2003, 394).

. . .Nevada may experience an insurgence of incorporating firms. . .leading the states in laws that favor managers and are detrimental to shareholders (Easmunt 2004, 32).

Introduction

The market for corporate law is not unlike any other market (Cary 1974; Winter 1977; Romano 1993; Abramowicz 2003). Easmunt (2004) provides a historical perspective of interstate competition, and its application to corporate law, under the U.S. federalist structure. According to Abramowicz (2003, 164), “(t)o beat the leading state, a trailing state would need to do more than duplicate the leading state’s corporate law structure. . .it would need to innovate boldly.”

“Delaware corporate law improves firm value. . .Delaware firms are worth significantly more than similar firms incorporated elsewhere” (Daines 2001, 525).¹ Delaware is home to more than fifty percent of all New York Stock Exchange (NYSE) listed firms and nearly sixty percent of all Fortune 500 companies, retaining 216 out-of-state corporations listed in the Fortune 500

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¹ Subramanian (2004) extended Daines (2001), providing evidence that small Delaware firms were worth more than small non-Delaware firms during the 1991 through 1996 period, but not afterwards.

(Easmunt 2004, 3–4). Nevada, however, has dramatically altered its laws to compete with Delaware, has specifically mentioned Delaware and its faults, and may be carving out a niche market and leading the states in a race-to-the-bottom (31–32).²

One Nevada Corporation, Universal Express, Inc. (Universal), was examined by Cataldo both before (2003) and after (2006) the Securities and Exchange Commission (SEC) issued a March 2004 litigation release (SEC 2004b). Universal was one of one-hundred and six firms alleged to have blamed naked shorting³ for their declining stock price (FW 2003 and 2004). The SEC found no evidence to support Universal's naked shorting claims, alleging, instead, that it was the Nevada Corporation, itself, that was the source of additional sales of shares of the firm's common stock.

This study began as an exploratory examination of the one-hundred and six firms alleged to have complained, formally or otherwise, of naked shorting abuses of their firm's equity securities. A preliminary review, focusing only on the state of incorporation, provided some dramatic results. Forty-eight (47 percent) of these firms were incorporated in the state of Nevada. Similar, state of incorporation-based results were achieved when twenty-six firms (8 or 36 percent from Nevada) were temporarily suspended from trading by the SEC in December 2004. Still, additional state of incorporation-based results were developed from the trading suspensions and the listing of thirty-eight (26 or 70 percent from Nevada) SEC "operation spamalot" firms.

Delaware firms were under-represented and Nevada firms were over-represented among naked shorting (NS), SEC 2004 suspension (SEC SUSP), and SEC 2007 "operation spamalot" (SEC SPAM) groups. At least one of the firms/alleged complainants of naked shorting was featured by a web-based news source, suggesting that the firm's management gave micro cap or over-the-counter bulletin board (OTCBB)⁴ stocks a "bad name" (IBC 2002),⁵ but provided no linkage to the firm's state of incorporation. This firm changed its state of incorporation from Delaware to Nevada, the same officer(s) changed the state of incorporation for another publicly traded micro cap from New Jersey to Nevada,

² In comparisons of regulations or laws, a race-to-the-bottom is said to occur when competition leads to relaxed regulations or laws.

³ Short-selling represents of the sale of shares that the seller borrows or does not own. Naked short-selling also contributes to selling pressures, putting downward pressures on the firm's stock price per share, but the seller does not borrow shares from shareholders with long positions in the firm.

⁴ The OTCBB began in June 1990, on a pilot basis. It was approved for permanent operation, by the SEC, in April 1997. The OTCBB differs from the National Association of Securities Dealers' Automated Quotation (NASDAQ) system in that: (1) quantitative, minimum listing requirements are not imposed, (2) automated trade executions are not provided for, and (3) pre-January 5, 1999, issuers of securities are not required to file periodic financial information with the SEC.

⁵ International Broadcasting Corporation (NASDAQ OTCBB: IBCS), is a fully reporting, publicly-traded Nevada Corporation.

and the same officer(s) formed a new corporation, also incorporated in the state of Nevada. Upon re-examination, it was determined that six of the twenty-six (23 percent) of the Nevada firms suspended by the SEC 2007 in “operation spamalot” also changed their state of incorporation to Nevada, from other jurisdictions, since April 2004.

The remainder of this paper is organized, as follows: First, a brief review of the relevant literature and the regulatory environment surrounding naked shorting, SEC regulation SHO and reverse splits, a practice engaged in by many of these Nevada corporations, is provided. Second, categorical comparisons are made between Delaware, Nevada, and other states selected by publicly traded firms for incorporation. Third, some comparisons between Delaware and highlighting relevant features of Nevada corporate law are provided. This section includes a brief review of Universal, a Nevada corporation, dissolved in an SEC-initiated and Court-forced Receivership, and a more fully developed case study of GEMZ, also incorporated in the state of Nevada, and two additional Nevada corporations led by the same executives. The fourth section provides some descriptive statistics, focusing and providing categorical or state of incorporation comparisons, complete with some rather compelling figures. A fifth section addresses the limitations of this study, which focuses on these small—or micro-cap Nevada firms. The sixth and final section summarizes this paper and its findings with respect to these Nevada firms.

Relevant Literature and the Regulatory Environment: Naked Shorting, SEC Regulation SHO and Reverse Splits

This section provides a review of the relevant academic literature and some operational definitions useful in understanding the naked shorting controversy, pursued by Universal and SEC Regulation SHO, designed to contribute transparency to the issue of related “fails to deliver” securities in a timely manner. Because GEMZ, and other Nevada corporations led by the same executives, seemed to follow a pattern of dilution, from the issuance of a relatively significant number of shares, followed by reverse splits and name and ticker symbol changes, this case study is preceded with references to some of the literature relating to stock splits, stock dividends and reverse splits.

Naked Shorting

In a series of articles, a listing of one-hundred and six firms were alleged to have complained, formally or otherwise, of naked shorting abuses of their firm's equity securities (FW 2003 and 2004). A short sale transaction involves the sale of stock that is borrowed.⁶ An affirmative determination must precede a short sale (NASD 2004a, b). The affirmative or positive determination rule requires that the investor make sure that long positions are available to borrow against, and is required under U.S. securities laws.

A naked short sale occurs when an affirmative determination has not taken

⁶ For the benefits associated with short-selling, see Lamont (2003).

place. This means that the short sale occurs when the investor does not know that the long shares can be borrowed. These short positions are not declared and these shares are not delivered to the buyer. Naked short selling artificially inflates ownership and devalues (or dilutes) the price of the equity security, effectively “counterfeiting” shares.

National Association of Securities Dealers (NASD) Rule 3350, also known as “the short rule,” prohibits short sales on a down bid, “bear raiding,” and “piling on.” However, NASD Rule 3370(b)(2)(B) provided an exception for primary market makers (NASD 2004a,b and SEC 2003a,b,c). Affirmative or positive determinations were not required if the long positions for these securities were available (to borrow) by the settlement data. Furthermore, a holder of convertible debentures is allowed to short securities covered by the convertibles.

Contemporary research suggest that issuance of floating-priced convertibles, also known as “death spirals,” are followed by significant negative abnormal returns (Hillion and Vermaelen 2004). The SEC and NASD are taking actions to reduce the practice of naked short selling by imposing more stringent requirements on U.S. broker-dealers (NASD 2004 a,b; SEC 2003 a,b,c; and SEC 2004a).

SEC Regulation SHO⁷

On October 22, 2003, the SEC held an open meeting for discussions on a new, proposed regulation (Reg SHO) relating to short selling, and replacing Rules 3b-3, 10a-1 and 10a-2 (SEC 2003a,b,c). Reg SHO (1) instituted a new uniform bid test, allowing exchange-listed and NASDAQ-NM short sales at prices above the consolidated best bid; (2) suspended the proposed bid test for specified highly liquid securities for a two-year pilot study; and (3) required short sellers to locate and borrow before selling short, adding this additional requirement to address “naked” short selling. Implementation of SEC RegSHO impacted OTC stocks (e.g., Bulletin Board (BB) and PK) on regional and national exchanges.

Many of the firms complaining of naked shorting are obscure, struggling, and financially challenged, with insignificant assets and negligible revenues.⁸ Some have complained that a small number of brokerage firms and market makers have engaged in or facilitated abusive short selling practices.⁹ In response to this concern, several companies have either announced plans to withdraw from the Depository Trust & Clearing Corporation’s electronic trading system (BW

⁷ This section benefited from the thoughts presented in an article by Bernstein (2003).

⁸ Dechow, Hutton, Meulbroek and Sloan (2001) found that short-sellers target firms with low fundamentals (e.g., earnings and book values) to take positions in these stocks with lower expected future returns. Desai, Ramesh, Thiagarajan and Balachandran (2002), in their examination of the NASDAQ market from June 1998 through December 1994, found that heavily shorted firms experience significant negative abnormal returns and are more likely to be delisted when matched with comparable size, book-to-market and momentum matched control firms.

⁹ Chae (2005) found that market makers act appropriately under conditions of information asymmetry, increasing price sensitivity before announcements. His findings suggest that market makers extract timing information from their order books.

2004b), or claimed the need to change their names (and ticker symbols) to thwart illegal short sellers (BW 2004a).

If naked short selling has truly affected these firms, the new rules would provide relief by inhibiting naked short selling practices. However, it is also possible that firms complaining of naked short selling are merely using this issue to explain the depressed price of their equity securities (e.g., Universal). Lamont (2002) found that firm actions designed to create short sale constraints also include explicit or implicit legal threats, investigations and lawsuits.¹⁰

Stock Splits, Stock Dividends and Reverse Stock Splits

U.S. research has established regular stock splits and stock dividends as positive information signals that the firm's stock is undervalued and that revealing this information reduces adverse selection costs to investors (Desai and Jain 1997; McNichols and Dravid 1990; Brennan and Copeland 1988; Lakonishok and Lev 1987; and Grinblatt, Masulis, and Titman 1984). Desai and Jain (1997), in their examination of 1–3 year performance following stock split and reverse split announcements during a twenty-five year period (1976–1991), concluded that abnormal returns for stock splits were positive and abnormal returns for reverse splits were negative. Reverse stock splits may enhance the liquidity of some stocks (Han 1995), but also may communicate to market participants that pre-reverse split earnings performance is not transitory and can be expected to persist in the future (Vafeas 2001).

State of Incorporation: A Comparison of Big Caps and Micro Caps

Table 1 summarizes the component stock contained in the Dow Jones Industrial Average (DJIA: N=30) by state of incorporation (n=7) and by state of principal and executive office location (n=13). This information was developed from the cover pages of official filing with the SEC.

Table 1

Dow Jones Industrial Stocks (N=30) by Jurisdiction or State of Incorporation and Jurisdiction or State of Principal Offices Location 2007

<u>State</u>	<u>Jurisdiction or State of Incorporation</u>	<u>Jurisdiction or State of Executive or Principal Office Location</u>
Arkansas	0	1
California	0	3
Connecticut	0	2
DELAWARE	20	1
Georgia	0	2

¹⁰ Jones and Lamont (2002), in their examination of the 1926 to 1933 time period, found that smaller firms were more expensive to short, but that lower subsequent returns are consistent with the hypothesis that they were overpriced (237). They used information published in the *Wall Street Journal* to develop data for this study.

<u>State</u>	<u>Jurisdiction or State of Incorporation</u>	<u>Jurisdiction or State of Executive or Principal Office Location</u>
Illinois	0	3
Michigan	0	1
Minnesota	0	1
NEVADA	0	0
New Jersey	3	3
New York	3	9
Ohio	1	1
Pennsylvania	1	0
Texas	0	2
Virginia	1	0
Washington	<u>1</u>	<u>1</u>
Total	<u>30</u>	<u>30</u>

Five of the thirty DJIA stocks (nearly seventeen percent) are incorporated in the same state where their principal offices are located.¹¹ The remaining twenty-five (more than 83 percent) are incorporated in states other than that in which their principal or executive offices are located. Twenty of the thirty stocks (nearly 67 percent) included in the DJIA are incorporated in the state of Delaware.

DJIA stocks are incorporated or have principal or executive offices in fifteen of the fifty United States (see Table1). The correlation between (1) state of incorporation and (2) state of principal or executive offices is very low and negative ($r = -0.013$).¹² Additional points warrant mention:

- None of the thirty DJIA firms are incorporated in the state of Nevada.
- None of the thirty DJIA firms have principal or executive offices in the state of Nevada.

Table 2 summarizes information for the stocks listed in the SEC “operation spamalot” trading suspension releases (N=38) by state (or jurisdiction) of incorporation (n=9) and by state (or jurisdiction) of principal and executive offices location (n=18). This information was developed from the cover pages of official filing with the SEC or, where otherwise not available, from the Pink Sheets (PK) website. The origin of and selection of this sample of firms is described below.

¹¹ These include: (1) American Express (AXP) in New York, (2) DuPont (DD) in Delaware, (3) Merck (MRK) in New Jersey, (4) Microsoft (MSFT) in Washington, and (5) Proctor and Gamble (PG) in Ohio.

¹² Where all fifty United States included, the correlation would be much higher ($r = 0.19$), where thirty-five (35) of the fifty (N=50) states would perfectly match with a value of zero (0).

Table 2

SEC *Operation Spamalot* Stocks (N=38) by Jurisdiction or State of Incorporation and Jurisdiction or State of Principal Offices Location 2007

<u>State</u>	<u>Jurisdiction or State of Incorporation</u>	<u>Jurisdiction or State of Executive or Principal Office Location</u>
Arizona	0	2
California	2	7
Colorado	1	1
Connecticut	0	1
DELAWARE	1	0
Florida	0	4
Illinois	1	1
Louisiana	2	1
Maryland	0	1
Minnesota	1	0
NEVADA	26	3
Oklahoma	0	1
Tennessee	0	1
Texas	0	1
Washington	0	1
Wyoming	<u>3</u>	<u>1</u>
Subtotal	37	26
Canada	1	9
China	0	1
Philippines	0	1
Thailand	<u>0</u>	<u>1</u>
Subtotal	<u>1</u>	<u>12</u>
Total	<u>38</u>	<u>38</u>

On March 8, 2007, the SEC suspended trading for thirty-five firms in what they referred to as “operation spamalot” (SEC 2007a). The trading suspensions lasted for ten business days, beginning on March 8 and terminating on March 21, 2007. All of these firms were quoted on the PK quotation service. Additional point warrants mention:

- Twenty-four of the thirty-five firms (69 percent) are incorporated in the state of Nevada, and
- Only one of the thirty-five firms (3 percent) is incorporated in the state of Delaware.

On October 4, 2007, the SEC suspended three additional firms as part of the same, anti-spam initiative (SEC 2007b). Again, the trading suspension lasted for ten business days (October 4 through October 17, 2007). This SEC release noted that questions had arisen regarding the “adequacy and accuracy of publicly-disseminated information concerning . . . companies’ assets. . . business opera-

tions and/or management. . .current financial condition. . .financing arrangements involving the issuance of the companies' shares." Therefore, conditions of information asymmetry contributed to these trading suspensions. Some additional points warrant mention:

- Two of the three firms (67 percent) are incorporated in the state of Nevada,¹³ therefore,
- Twenty-six of the thirty-eight firms (68 percent), in aggregate, are incorporated in the state of Nevada.

Furthermore,

- Six of the thirty eight firms (16 percent) changed their state of incorporation from some other jurisdiction to Nevada over a twenty-five month period (between April 2004 and April 2006), immediately preceding the SEC trading suspensions, and
- Seven of the twenty-six firms (27 percent) incorporated in the state of Nevada are firms with principal or executive offices in Canada.

For the SEC trading suspension sample of firms, only nine of the thirty-eight firms are incorporated in the same state where their principal offices are located.¹⁴ The remaining twenty-five are incorporated in states other than that in which their principal or executive offices are located. The correlation between (1) state (or jurisdiction) of incorporation and (2) state (or jurisdiction) of principal or executive offices is very low for this sample of firms ($r = 0.14$).

What could explain the dominance of Delaware, as a state of incorporation, for the DJIA (large—or big-cap) stocks? What could explain the dominance of Nevada and the desire to elect to change from Delaware or other states to the state of Nevada for the firms (later) experiencing SEC-initiated trading suspensions due to unacceptable conditions or cases of information asymmetry? The next section provides some insights, based on seminal papers on this topic, addressing possible explanations for the Delaware versus Nevada state of incorporation selection process.

Delaware versus Nevada

Delaware's dominance in the competition for corporations originates from its lengthy history, predictability and the stability of Delaware corporate law (Easmunt 2004, 23) and the efficiency and speed of its Court of Chancery (24). Delaware has won the race-to-the-top (Winter 1977).¹⁵ *The result is state*

¹³ These include two firms with principal or executive offices in California and Washington.

¹⁴ Only three of the nine are Nevada firms.

¹⁵ Race-to-the-top and race-to-the-bottom hypotheses and theoretical constructs or applications are not restricted to any single area of public policy or topical research. State competition in higher education (Bailey, Rom and Taylor 2004) and pollution (Millimet and List 2003) represent diverse examples, beyond the scope of this paper, which focuses on the market for corporate law.

On an international level, Reese and Weisbach (2002) examined minority shareholder protection

corporate tax revenues of approximately three thousand dollars per four person household (emphasis added; Easmunt 2004, 20). *Approximately fifteen to twenty percent of Delaware's revenue is directly attributable to corporate franchise tax revenues and related fees* (emphasis added; Engledow 2002, 146).

The race-to-the-bottom hypothesis or theory (Cary 1974) is based entirely on the assumption that states will move toward management-friendly corporate laws to attract incorporation and re-incorporations and will, therefore, benefit from related franchise tax revenues (Engledow 2002, 145). Nevada Corporate Planners, Incorporated, one of many firms specializing in and touting Nevada as a superior choice for incorporation, lists "16 Reasons to Incorporate in Nevada" on their web site, as follows:

Nevada (1) protects the corporate veil,¹⁶ (2) protects the board of directors and officers,¹⁷ (3) provides indemnification of officers automatically when articles are filed,¹⁸ (4) has no state corporate or franchise taxes, (5) does not exchange information with the Internal Revenue Service (IRS),¹⁹ (6) has low fees,²⁰ (7) allows for thinly capitalized corporations,²¹ (8) offers the best protection for board of directors from shareholder lawsuits,²² (9) requires only a legal purpose for corporate formation, (10) has no joint or several liability, (11) only requires an update for the list of officers annually, (12) allows one person to hold all corporate positions,²³ (13) does not require members to be listed in state records, (14) does not require shareholders, directors and officers to be U.S. citizens or live or hold meetings in Nevada, (15) allows corporations to purchase, hold, sell or transfer

as a motivating factor for foreign firms seeking United States cross-listings. They found evidence to support their hypothesis—the firm's desire to protect shareholder rights was a significant reason why some non-U.S. firms cross-listed in the United States (66). As noted in their conclusions section, "(i)t is well-recognized that legal protections of shareholder interests can affect valuations and the ability to raise capital externally (see La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997, 1998 and 1999; Grinblatt and Titman, 1998, 8)."

¹⁶ Delaware provides similar protections against piercing the corporate veil, but Nevada is superior, when these protections are combined with those for the board of directors.

¹⁷ As of 2004, only five other states, Louisiana, Maryland, New Hampshire, New Jersey, and Virginia, protected both directors and officers.

¹⁸ See Nevada Revised Statutes 78.307(1). This protection exists whether stated in the firm's articles of incorporation or not.

¹⁹ Texas is the only other state that does not exchange information with the IRS. See Internal Revenue Code Sections 6103(a), 6103(b)(1), 6103(b)(2)(A), 6103(d), 6103(b)(5), and Commerce Clearing House Standard Federal Tax Reporter, Vol. 15 (2002), 36,894.576 at 64,490.

²⁰ This advantage no longer exists. For example, state fees for incorporating in Nevada approximate \$260 compared to Delaware fees of approximate \$89. See <http://www.corporate.com/state-fees.htm> for a contemporary (2007) listing of all filing and correspondent fees, by state.

²¹ In other states, thin capitalization may provide justification for piercing of the corporate veil.

²² Gross negligence must be proved. No other state provides for such a high standard.

²³ See Agrawal and Chadha (2005) for an examination of how this provision and other provisions available in Nevada have related to past corporate governance issues and accounting scandals.

shares of its own stock, and (16) allows corporations to issue stock for services.²⁴

Reasons (1), (2), (3), (4), (5), (6), (8), (9), (10) and (14) are specifically mentioned and, according to Easmunt (2004, 32), are most representative of Nevada's efforts to emulate and compete with Delaware in the market for corporate law and related state revenues. Specifically, Easmunt notes that

Nevada has structured its corporate laws to protect managers and corporate owners from as much personal liability as possible. . .the near impossibility of piercing the corporate veil (32). . .the case law has become so protective of corporate owners that the corporate veil has only been "pierced" two times in the last twenty four years (33).

Similarities present themselves, when comparing Delaware to Nevada laws for selection as a state of incorporation. Neither state taxes corporate shares or requires the issuance of share certificates. Both states permit a single person corporation, both states have a no minimum capital requirement, both states have a no annual report requirement (until the anniversary of the date of incorporation), and both states allow meetings to be held at any location. However, significant differences are also apparent. Transparency—and information asymmetry-related factors are more favorable to management (less favorable to shareholders) when considering Nevada versus Delaware incorporation, as follows:

- Nevada does not impose a requirement to report the number of shares issued and outstanding,
- Nevada does not require the reporting of annual stockholder and director meetings,
- Nevada does not collect and/or share tax information with the Internal Revenue Service, and
- Nevada does not require that the corporation even report places of business outside of Nevada (the state of incorporation).

Furthermore,

- Nevada provides for nominee shareholders,
- Nevada permits unlimited shares of stock at any par value,
- Nevada (is the only state that) permits bearer stock, and
- Nevada statutorily indemnifies officers, directors, employees and agents.

The above suggests that a Nevada corporation might, for example, be well within Nevada state law, its requirements and corporate officer/director protections, were it to dilute ownership interests of existing shareholders, resulting from a decision by the board of directors to increase the sale of common stock, without any public release of information to make existing shareholders aware of this dilutive action in any timely manner (items number 1, 5 and 6, above).

²⁴ Directors may determine the value of these transactions and their decision is final.

This was the case when Universal (Cataldo 2003, 119–132, Cataldo 2006, and Norris 2007), a Nevada corporation, complained that the firm's stock was being naked shorted. Universal was found “to exist primarily as a vehicle for fraud” by the SEC, when it was discovered that Universal, itself, was the source of the additional shares. Previously, Universal had been one of many firms complaining that the SEC did not ‘crack down’ on “naked short selling,” the practice of selling shares without owning or borrowing them (Norris 2007). Universal was characterized as the “naked shorting poster child” by one financial press news reporter (Redmond 2007). Universal has been dissolved by a Court-appointed Receiver, following SEC-initiated litigation against them. The CEO of Universal was incarcerated for a short period.

Universal versus Nevada—Costs, Benefits, and the Public Interest

In a recent judgment, Universal (a Nevada corporation) was ordered to pay nearly \$22 million to the clerk of the Southern District of New York by April 16, 2007. Universal's chief executive officer (CEO) and general counsel were ordered to pay more than \$3 million and nearly \$8 hundred thousand, respectively. These costs, of course, may or may not include all costs (e.g., those incurred by SEC actions, Courts, and/or the Receiver).

By comparison, the revenues generated by Nevada for corporate filing fees for all firms physically located and/or headquartered outside of Nevada for the 2002 fiscal year (FY) was estimated at \$34 million (NCH 2004). This amount included an increase in fees (NCH 2004 and Heller 2002), as Nevada appeared to have moved from a low cost substitute or provider for corporate law and related filings to a position where the state of Nevada could enjoy the benefits associated with the imposition of a premium price subcomponent. The Nevada Secretary of State (Heller 2002, 9) elaborates:

. . . while Nevada's Commercial Recordings Division has experienced only a slight gain in business (approximately 1% over fiscal year 2001 new filings), other states have experienced decreases from 5 – 33%, including *Delaware, which reported a decrease of more than 33% in new corporations* (emphasis added).

The above is consistent with Bebchuk and Cohen (2003, 394), Easmunt (2004, 32–33), and NCH (2004, 5), where the latter provides an historical perspective:

Nevada adopted its Revised Statutes for corporations in 1987. . . based primarily on *Delaware* (emphasis added) corporate statutes. . . looking for new ways to increase its revenue.

Universal is, of course, only a single Nevada corporation. Another Nevada corporation, also cited as having been adversely impacted by naked shorting was investigated.

A Case Study—GEMZ Corporation

GEMZ is one of the more than one-hundred firms alleged to have filed or registered complaints of naked shorting to explain the decline in their firm's stock

price per share. GEMZ was characterized as one of the most notorious firms on the Raging Bull (RB) stock-chat message boards,²⁵ because of their significant reverse splits, and was the topic of a negative June 17, 2002, electronic article (IBC 2002). GEMZ also issued convertible debentures (CDs).

GEMZ Corporation (OTCBB: GZMP) *changed their state of incorporation from Delaware to Nevada in February 2002* (emphasis added). They also changed their name and ticker symbol several times during that period. A summary of corporate name and ticker symbol changes is provided in Table 3.

Table 3
 Corporate Names and Ticker Symbols for GEMZ Corporation

<u>Corporate Name Changes</u>	<u>Ticker</u>	<u>Approximate Begin Date</u>	<u>Approximate End Date</u>
Travelnet International Corporation	TVNT		7-Oct-98
United Ventures Group, Incorporated	UVGI	8-Oct-98	5-Jun-00
“	UVGI(E)*	6-Jun-00	10-Jul-00
“	UVGI	11-Jul-00	20-Oct-00
American Jewelry Corporation	AMJY	21-Oct-00	20-May-01

State of Incorporation change from DELAWARE to NEVADA in February 2002

American Jewelry Corporation	AMJC	20-May-01	22-Apr-02
“	AMJC(E)	23-Apr-02	23-Apr-02
“	AMJC	24-Apr-02	28-May-02
“	AMJC(E)	29-May-02	6-Jun-02
“	AMJC	7-Jun-02	17-Jun-02
“	AMJW	18-Jun-02	24-Jun-02
MSM Jewelry Corporation	MSMJ	25-Jun-02	27-Aug-02
“	MSMJ(E)	28-Aug-02	unknown
“	MSMC	unknown	29-Oct-03
GEMZ Corporation	GEMZ	30-Oct-03	unknown
“	GMZC	unknown	21-May-04
“	GMZP	22-May-04	

This editorial article noted similarities between GEMZ (GZMP), a Nevada corporation, and two other Nevada corporations: MTN Holdings, Inc. (MTND)

²⁵ Attempting to chronicle the firm’s history is difficult. However, with the assistance of a variety of SEC filings and other Internet-based sources, including self-identified shareholders on the RB stock-chat message board (e.g., “elmoda” and RB message number 92331, dated September 11, 2002), the firm’s name and ticker symbols history was developed.

* The “E” suffix in the firm’s ticker symbol notifies the public that the firm is delinquent in required SEC filings.

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and Intrac, Inc. (ITRD). All three firms were operating under the same President and CEO. In a September 25, 2003, press release, MSM Jewelry (the former name for GEMZ) reported the resignation of their President and CEO from MSM (BW 2003). On December 1, 2004, the SEC temporarily suspended trading of GEMZ shares (SEC 2004c). All three firms are discussed below.

Table 4a

Reverse Splits for GEMZ Corporation

	<u>Reverse Split (RS)</u>	<u>RS-Adjusted Shares</u>
Begin		7,875,000,000,000
10/07/1998	300	26,250,000,000
5/02/2001	300	87,500,000

**State of Incorporation change
from DELAWARE to NEVADA
in February 2002**

6/17/2002	7,000	12,500
5/22/2003*	125	100
5/24/2004**	<u>100</u>	1
End	<u>7,875,000,000,000</u>	

Table 4b

Reverse Splits for MTN Holdings, Incorporated*

	<u>Reverse Split (RS)</u>	<u>RS-Adjusted Shares</u>
Begin		190,000,000
7/16/2001	100	1,900,000
11/08/2001	950	2,000

**State of Incorporation change
from NEW JERSEY to NE-
VADA in December 2000**

* MSM Jewelry had 28.0 million post-reverse split common shares issued and outstanding (PK).

** Post-reverse split, there were 7.5 million common shares issued and outstanding (i.e., 750.0 million pre-reverse split shares) and only 5.0 million of these shares were in the public float. Therefore, assuming from the post-5/22/2003 through the 5/24/2004 100:1 reverse split period that the 2.17 billion shares traded at an average price per share of \$0.0017, sales of an additional 722.0 million shares (i.e., 750.0 less 28.0) may have generated approximately \$1.23 million (gross) for GEMZ Corporation.

* The state of incorporation was changed from New Jersey to Nevada in December 2000, concurrent with the firm's name change (PK).

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	<u>Reverse Split (RS)</u>	<u>RS-Adjusted Shares</u>
4/10/2002**	<u>2,000</u>	1
End	<u>190,000,000</u>	

Table 4c
 Reverse Splits for ITRD, Incorporated*

	<u>Reverse Split (RS)</u>	<u>RS-Adjusted Shares</u>
Begin		95,000
12/21/2001	10	9,500
7/05/2002	<u>9,500</u>	1
End	<u>95,000</u>	

Tables 4a, 4b and 4c summarize the reverse splits for GEMZ, MTN and ITRD. The reverse splits for GEMZ occurred over a period of less than six years, effectively converting 7.875 trillion shares (October 6, 1998), in pre-reverse split terms, to 1 share (May 23, 2003). The largest (7,000:1) reverse split occurred during June 2002; *four months after the firm's change in state of incorporation from Delaware to Nevada* (emphasis added; see Table 4a).

With few exceptions, the sentiment on the GEMZ RB stock-chat message board was very negative. Some alleged that the change in the state of incorporation facilitates further reverse splits, combined with convertible debenture (CD) issues, without disclosure. In fact, many of the posts on this message board related to the question of just how many shares were issued and outstanding at any point in time (e.g., information asymmetry).

The three quotes that follow were selected from and represent the sentiment on the RB stock-chat message boards²⁶ for the other two firms identified in the IBC News Network article:

The volume is dilution. CD conversion. . .(t)his company sells shares to buy other companies. . .(t)hen it does a R/S. . .takes. . .shares back. . .sells them to new investors. . .(a)nd so on. . .²⁷

The only thing they sell is stock. . .²⁸

. . .do some research regarding Nevada corporate law. . .I. . .avoid all

** MTN Holdings, Incorporated had 0.399 million post-reverse split common shares issued and outstanding (PK).

* Organized on September 6, 2000 (date of inception) under the laws of the State of Nevada.

²⁶ For some examples of recent academic research on the volume and/or relevance of information contained on the stock chat message boards, see Antweiler and Frank (2004).

²⁷ RB message board post number 454 by florida_sand on December 11, 2001. For academic research results on the effects of "death spiral convertibles" (e.g., the "CD conversion" referred to), see Hillion and Vermaelen (2004).

²⁸ RB message board post number 82 by billfish_98083 on January 22, 2002.

OTC Nevada corps. They are the kiss of death.²⁹

The reverse splits for MTN, also a Nevada corporation and also addressed in the IBC News Network article, occurred over a period of a single year. MTND³⁰ effected three reverse splits, converting 190 million shares (July 15, 2001), in pre-reverse split terms, to 1 share (April 11, 2002). The firm had 399 million (post-reverse split) shares as of April 24, 2002 (PinkSheets (PK)).

The third firm noted in the IBC News Network article, ITRD³¹, was also incorporated in the state of Nevada. This firm had two reverse splits over an 8 month period (PK).

In recent years, the information contained on the various stock chat message boards has attracted the attention of regulators, investor relations professionals, and academics.³² Wysocki (1999 and 2000) concluded that a large increase in stock chat message board posts for a publicly traded firm may suggest investor discontent and signal the need for a public information release, to reduce conditions of information asymmetry. He also found that the volume of overnight stock chat message board posts predicted changes in stock trading volume and returns on the following trading day (1999). Similar conclusions were reached by Cataldo (2003, 124–126), in his examination of stock chat message volume for Universal (a small—or micro-cap Nevada corporation, previously addressed), and to Antweiler and Frank (2004), in their examination of message board volume and sentiment for large of big cap firms.

Whether or not Nevada is experiencing a net inflow of firms (Bebchuk and Cohen 2003, 394) because they favor insiders and its corporate laws are detrimental to shareholders (Easmunt 2004, 32) is a very broad research question and beyond the scope of this paper. However, an examination of (1) firms complaining of naked short selling as an explanation for the depressed price of their equity securities (e.g., Universal and GEMZ), where at least one case was recently challenged by the SEC (i.e., Universal), and the inclusion of (2) firms recently experiencing trading suspensions by the SEC (2004 and 2007), represents a reasonable starting point for exploratory analysis. In the absence of evidence to the contrary, we expected the categorical distribution of state of incorporation for each of these samples to approximate that of the universe of all publicly traded firms.

Comparative and Categorical Analyses

The examination of micro cap firms is not easily facilitated by the use of

²⁹ Paraphrase from “Buzz” in RB message number 142, dated November 27, 2001, on the MTN Holdings, Incorporated (OTCBB: MTND) stock-chat board.

³⁰ Previous ticker symbols included MTNC, MTNO, MTND and MTNDE.

³¹ Previous ticker symbols include IRAC.

³² See, for example, Cataldo and Killough (2002), where the price per share for both large—and small-/micro-cap stocks were effectively manipulated by individuals using the stock chat message boards for both short and long position-based trading strategies. In both cases, the SEC intervened.

Compustat or alternative data bases commonly used for financial economics-related market studies by academics. In the case of this study and paper, the focus on firms incorporated in the state of Nevada exacerbates this problem. These tend to be micro caps, with frequent name and ticker symbol changes (see the case study on GEMZ, above), thinly traded and, therefore, ignored by financial analysts. It is for this reason that this study (and paper) must rely on relatively descriptive measures and cannot employ, for example, a semi-strong or strong form market and/or abnormal returns-based model.

Five separate data sets are employed for state of incorporation or categorical comparisons (see Appendix Table for summarized data):

Two were selected for state of incorporation comparison: (1) the December 31, 2003 Compustat current and research files, or the universe of all public firms (COMP2004 at n=16,421) and (2) the firms comprising the Dow Jones Industrial Average during 2007 (DJIA2007 at n=30). In the former case (COMP2004), more than fifty-one percent of the firms are incorporated in the state of Delaware and fewer than 5 percent of the firms are incorporated in the state of Nevada. In the latter case (DJIA2007), more than sixty-seven percent of the firms are incorporated in the state of Delaware and no firms are incorporated in the state of Nevada.

These were compared against the three samples developed and addressed earlier in this paper: (3) the one-hundred and two U.S. firms associated with naked shorting complaints in late 2004 (NS2004 at n=102; n=106 less 4 non-U.S. firms), (4) the twenty-two U.S. firms targeted in the first SEC suspension on December 1, 2004 (SECSUSP2004 at n=22; n=26 less 4 non-U.S. firms), and (5) the thirty-eight U.S. firms targeted and suspended from trading by the SEC in 2007 in “operation spamalot” (SECSUSP2007 at n=37; n=39 less 1 non-U.S. firm).

Equations (1a), (1b) and (1c) were used to generate Figures 1a, 1b and 1c, respectively, for the Compustat comparisons, as follows:

$$\text{COMP2004}_{\text{Percent}} - \text{NS2004}_{\text{Percent}} = \text{NS2004DIFF}_{\text{Percent}} \quad (1a)$$

$$\text{COMP2004}_{\text{Percent}} - \text{SECSUSP2004}_{\text{Percent}} = \text{SECSUSP2004DIFF}_{\text{Percent}} \quad (1b)$$

$$\text{COMP2004}_{\text{Percent}} - \text{SECSUSP2007}_{\text{Percent}} = \text{SECSUSP2007DIFF}_{\text{Percent}} \quad (1c)$$

Equations (2a), (2b) and (2c) were used to generate Figures 2a, 2b and 2c, respectively, for the DJIA comparisons, as follows:

$$\text{DJIA2007}_{\text{Percent}} - \text{NS2004}_{\text{Percent}} = \text{NS2004DIFF}_{\text{Percent}} \quad (2a)$$

$$\text{DJIA2007}_{\text{Percent}} - \text{SECSUSP2004}_{\text{Percent}} = \text{SECSUSP2004DIFF}_{\text{Percent}} \quad (2b)$$

$$\text{DJIA2007}_{\text{Percent}} - \text{SECSUSP2007}_{\text{Percent}} = \text{SECSUSP2007DIFF}_{\text{Percent}} \quad (2c)$$

Figure 1a

(See Appendix Table for Data)

Compustat (COMP2004)

v.

Naked Short (NS2004)

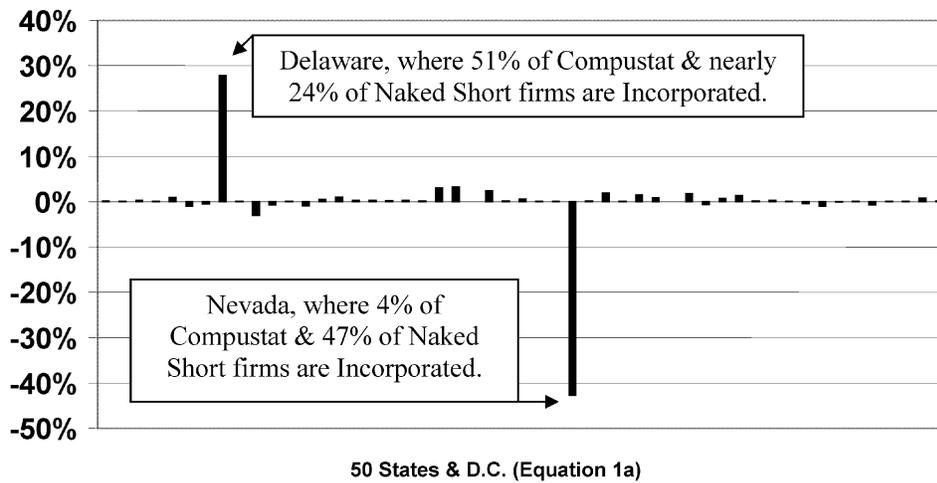


Figure 1b

(See Appendix Table for Data)

Compustat (COMP2004)

v.

SEC Suspensions (SECSUSP2004)

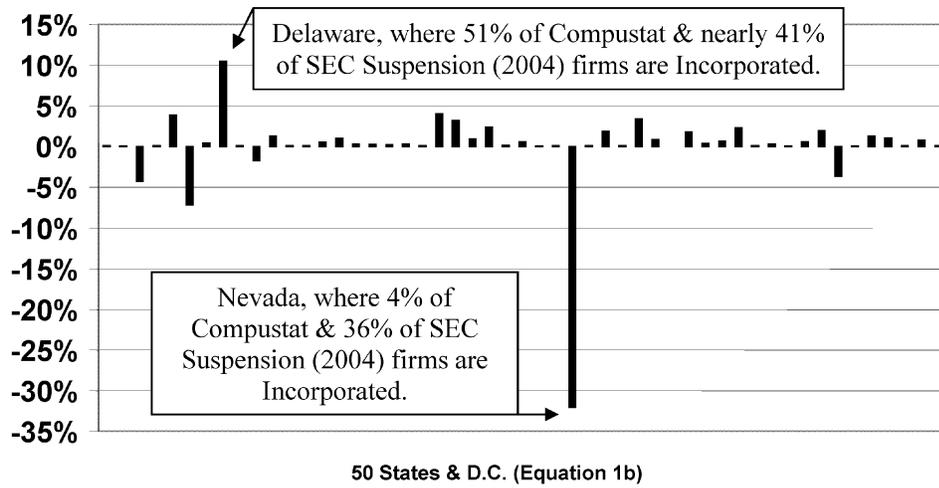


Figure 1c

(See Appendix Table for Data)

Compustat (COMP2004)

v.

SEC Suspensions (SECSUSP2007)

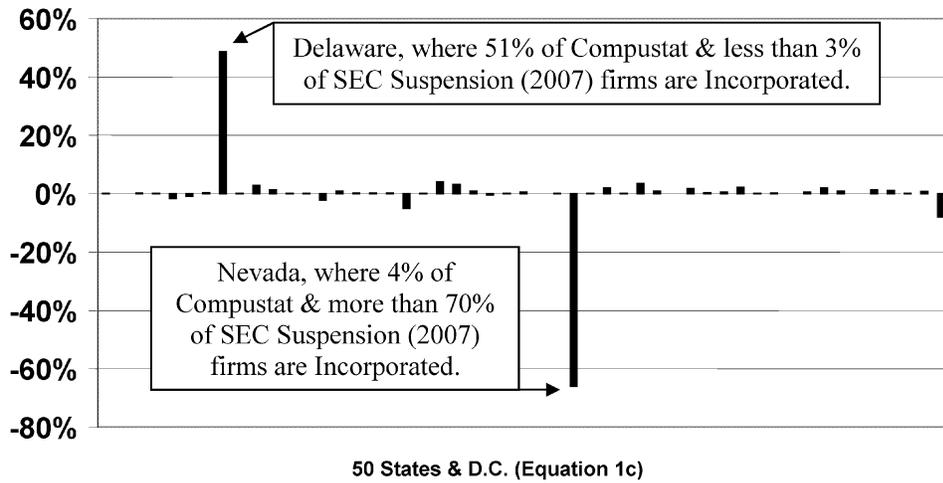


Figure 2a
(See Appendix Table for Data)

DJIA (DJIA2007)
v.
Naked Short (NS2004)

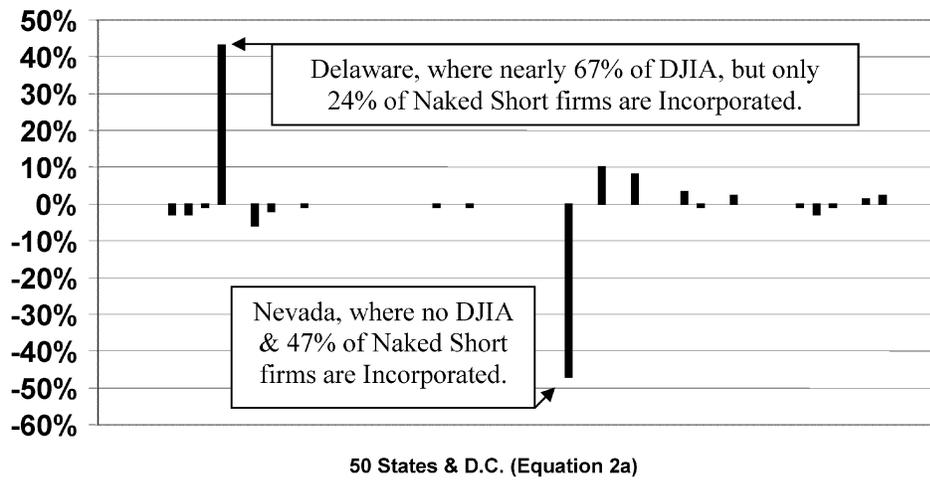


Figure 2b

(See Appendix Table for Data)

DJIA (DJIA2007)

v.

SEC Suspensions (SECSUSP2004)

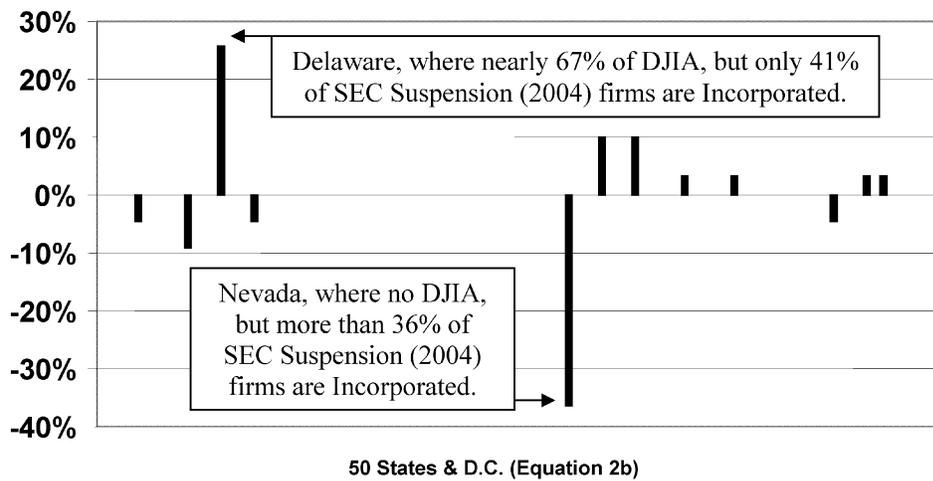
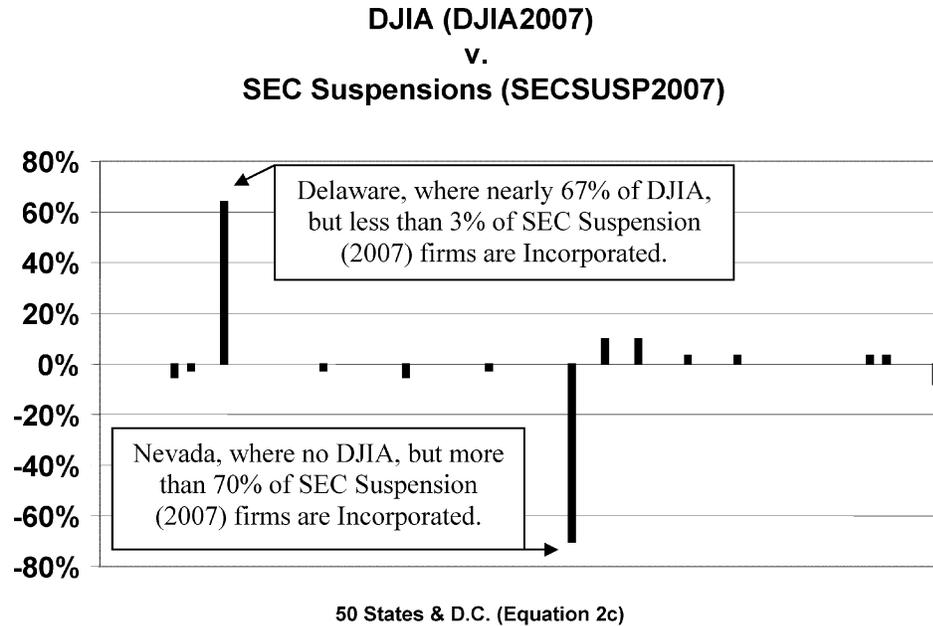


Figure 2c
(See Appendix Table for Data)



All Figures clearly suggest that the category or state of incorporation for the NS2004, SECSUSP2004 and SECSUSP2007 samples significantly over-represent Nevada and significantly under-represent Delaware. This is the case for either COMP2004 and DJIA2007 standards or categorical comparisons. Statistical tests, in both of these cases, appear unnecessary, but Pearson product moment correlations are summarized in Table 5, for both figure and equation series, where $n < 51$ measures tests a smaller DJIA-based sample, both before and after the elimination of no representation states (i.e., matching zeros that might otherwise drive statistical results) and the District of Columbia.

Table 5
Pearson Product Moment Correlation (r)
Results and Sample Sizes

COMP2004 series					DJIA2007 series
<u>Figure/Equation</u>	<u>r</u>		<u>r</u>	<u>r</u>	<u>Figure/Equation</u>
1a	0.49 (n=51)	NS2004	0.41 (n=51)	0.35 (n=20)	2a
1b	0.77 (n=51)	SECSUSP2004	0.70 (n=51)	0.64 (n=12)	2b
1c	0.08 (n=51)	SECSUSP2007	0.00 (n=51)	-0.13 (n=14)	2c

DJIA-based correlations are consistently lower, as are those developed from

smaller samples, after states with matching zeros have been eliminated before testing. However, correlations between NS2004, SECSUSP2004 and SECSUSP2007 measures, all of which suggest an over-representation of firms incorporated in the state of Nevada, are relatively high, as follows:

- NS2004 × SECSUSP2004 (r = 0.90; n = 19)
- NS2004 × SECSUSP2007 (r = 0.88; n = 22)
- SECSUSP2004 × SECSUSP2007 (r = 0.58; n = 11)

Finally, the Pearson product moment correlation between the COMP2004 and DJIA2007 measures is quite high, at $r = 0.97$ ($n = 51$).

Limitations

Customary, fundamental analysis-based techniques and regression models have not been applied in this study. These measures, for micro-cap firms, are frequently unavailable through Compustat, where a majority of the firms in a sample may be lost for a variety of reasons, including the firm's failure to file timely reports, as suggested by the SEC suspension of GEMZ stock in the case study described above and resulting in the development and examination of the Suspend sample. The loss of observations is, frequently, so significant as to represent a potentially indeterminable bias. Furthermore, many of these firms are thinly traded. Some may go several trading days (or even weeks) without trading, making traditional models difficult to employ.³³ Despite these limitations, the descriptive measures suggest that Nevada is attracting firms that are, in turn, attracting the SEC and leading to SEC suspensions for information asymmetry.

Summary of Findings

Easmunt (2004) found that Nevada is competing against Delaware in the market for state incorporation in what might be characterized as a race-to-the-bottom. An extension of Daines (2001) by Subramanian (2004) suggests that the small (e.g., micro-cap) Delaware effect or firm component has disappeared for the post-1996 period. These results, combined with those from the present study, suggests that Delaware retains its niche in a race-to-the-top for larger or big-cap firms, while Nevada is making market share gains in the small—or micro-cap firm niche. The Nevada strategy appears to be based on state law that supports conditions of information asymmetry and is detrimental to shareholders (Easmunt 2004).

GEMZ, the firm selected for the case study presented in this paper, changed their state of incorporation from Delaware to Nevada in February 2002. They followed this change in state of incorporation with a 7,000:1 reverse stock split (see Table 4a), less than four months later. GEMZ was one of 106 firms

³³ See, for example, Daines (2001), where ordinary least square (OLS) estimates are developed for fundamentals/independent variables including firm size (proxied by the logarithm of the firm's sales), number of business segments, research and development expense scaled by assets, etc. (534).

complaining (or alleged to have complained) of naked shorting as an explanation for their depressed stock price. GEMZ was also one of 26 firms suspended from trading by the SEC in late 2004, for failure to provide timely information to shareholders in the form of SEC filings. Therefore, researchers interested in extending the present study are likely to be faced with difficulties when attempting to extend the research finding from prior studies with traditional, fundamentals-based statistical models and methodologies. The present study represents a first step toward an alternative to these technologies, focusing on reverse splits, which may be combined with the issuance of toxic convertibles.

The GEMZ case study was selected for its extremity and because it supports the Delaware—Nevada fact pattern and the indirect evidence contained in the recent literature. There have been, to the best of our knowledge, no studies specifically addressing or identifying small—or micro-cap firms as the niche market that Nevada may be attracting. The present study provides evidence that firms complaining of naked shorting are disproportionately represented by Nevada corporations. To the extent that these firms encouraged the passage of SEC Regulation SHO, self-serving motives may also warrant further examination and extensions by both academics and regulators. Should Nevada begin to attract larger firms in the future, traditional technologies and statistical models and techniques may prove useful.

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Appendix Table

Descriptive Measures by State of Incorporation

Appendix Table

Descriptive Measures by State of Incorporation

State	From Table 3						From Table 4				
	COMP		DJIA	DJIA	NS	NS	SECSUSP		SECSUSP	SECSUSP	
	2004	Pct	2007	Pct	2004	Pct	2004	Pct	2007	Pct	
AL	18	0.11%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
AK	8	0.05%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
AZ	45	0.27%	0	0.00%	0	0.00%	1	4.55%	0	0.00%	
AR	15	0.09%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
CA	635	3.87%	0	0.00%	3	2.94%	0	0.00%	2	5.41%	
CO	318	1.94%	0	0.00%	3	2.94%	2	9.09%	1	2.70%	
CT	71	0.43%	0	0.00%	1	0.98%	0	0.00%	0	0.00%	
DE	8,435	51.37%	20	66.67%	24	23.53%	9	40.91%	1	2.70%	
DC	14	0.09%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
FL	464	2.83%	0	0.00%	6	5.88%	1	4.55%	0	0.00%	
GA	214	1.30%	0	0.00%	2	1.96%	0	0.00%	0	0.00%	
HI	16	0.10%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
ID	15	0.09%	0	0.00%	1	0.98%	0	0.00%	0	0.00%	
IL	87	0.53%	0	0.00%	0	0.00%	0	0.00%	1	2.70%	
IN	164	1.00%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
IA	47	0.29%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
KS	42	0.26%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
KY	37	0.23%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
LA	51	0.31%	0	0.00%	0	0.00%	0	0.00%	2	5.41%	
ME	23	0.14%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
MD	665	4.05%	0	0.00%	1	0.98%	0	0.00%	0	0.00%	
MA	521	3.17%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
MI	158	0.96%	0	0.00%	1	0.98%	0	0.00%	0	0.00%	
MN	393	2.39%	0	0.00%	0	0.00%	0	0.00%	1	2.70%	
MS	28	0.17%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
MO	96	0.58%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
MT	10	0.06%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
NE	14	0.09%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
NV	713	4.34%	0	0.00%	48	47.06%	8	36.36%	26	70.30%	
NH	18	0.11%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
NJ	311	1.89%	3	10.00%	0	0.00%	0	0.00%	0	0.00%	
NM	17	0.10%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
NY	558	3.40%	3	10.00%	2	1.96%	0	0.00%	0	0.00%	
NC	140	0.85%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
ND	4	0.02%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
OH	293	1.78%	1	3.33%	0	0.00%	0	0.00%	0	0.00%	
OK	63	0.38%	0	0.00%	1	0.98%	0	0.00%	0	0.00%	
OR	108	0.66%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	
PA	381	2.32%	1	3.33%	1	0.98%	0	0.00%	0	0.00%	
RI	24	0.15%	0	0.00%	0	0.00%	0	0.00%	0	0.00%	

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What Happens in Vegas Doesn't Always Stay in Vegas

SC	47	0.29%	0	0.00%	0	0.00%	0	0.00%	0	0.00%
SD	9	0.05%	0	0.00%	0	0.00%	0	0.00%	0	0.00%
TN	96	0.58%	0	0.00%	1	0.98%	0	0.00%	0	0.00%
TX	323	1.97%	0	0.00%	3	2.94%	0	0.00%	0	0.00%
UT	149	0.91%	0	0.00%	1	0.98%	1	4.55%	0	0.00%
VT	10	0.06%	0	0.00%	0	0.00%	0	0.00%	0	0.00%
VA	212	1.29%	1	3.33%	2	1.96%	0	0.00%	0	0.00%
WA	174	1.06%	1	3.33%	1	0.98%	0	0.00%	0	0.00%
WV	17	0.10%	0	0.00%	0	0.00%	0	0.00%	0	0.00%
WI	127	0.77%	0	0.00%	0	0.00%	0	0.00%	0	0.00%
WY	23	0.14%	0	0.00%	0	0.00%	0	0.00%	3	8.11%
TTL US	16.421	100.00%	30	100.00%	102	100.00%	22	100.00%	37	100.00%
OTHER			0		4		4		1	

0030

[ST: 53] [ED: 10000] [REL: 58-01]

Composed: Mon Jul 13 13:42:07 EDT 2009

XPP 8.1C.1 Patch #5 SC_00738 nlp 520 [PW=450pt PD=684pt TW=360pt TD=580pt]

VER: [SC_00738-Local:24 Aug 08 09:32][MX-SECNDARY: 01 Jul 09 10:33][TT: 25 Jun 09 10:01 loc=usa unit=00520-ch0007] 0