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Hemispherx Biopharma

V.

Manuel P. Asensio et al

Report of Robert W. Lowry
January 31, 2001

RL Consulting Services
Leesburg VA

Table of Contents

- I. Qualifications
- II. Engagement with Litigation
- III. Basis for Opinion
- IV. Opinion

Appendices

- I. Exhibits
- II. Robert W. Lowry, curriculum vitae
- III. Robert W. Lowry, cases testified and served as expert (past four years)

Qualifications

My qualifications are set forth in the curriculum vitae which is attached to this report. I have more than 28 years of experience with the Securities and Exchange Commission ("SEC"), including 23 years in the Division of Market Regulation. I have conducted numerous broker dealer examinations and self-regulatory oversight inspections of the National Association of Securities Dealers, Inc ("NASD") and the New York Stock Exchange ("NYSE"), while working in the Division of Market Regulation. The Division of Enforcement staff frequently consulted with me on cases involving markups, over-the-counter trading and sales practice abuses. I also assisted the Division of Enforcement on complex investigations and litigation matters pertaining to broker dealer activities, including matters involving market manipulations. My enforcement experiences included taking investigative testimony, analyzing trading data, preparing affidavits and schedules, and giving factual and expert witness testimony in federal court on three different occasions (SEC v. First Jersey Securities; SEC v. Thomas James and U.S. v. Eric Wynn). I was successfully qualified and used as an expert in the areas of markups (SEC v.

Thomas James) and securities trading in the over-the-counter market (U.S. v. Eric Wynn).

I have provided training to the Department of Justice, the NASD, the North American Securities Administrators Association, and the SEC on subjects relating to broker dealer regulation, underwriting, and trading in the over the counter market ("OTC Market").

Since May 1996, I have been self-employed as a consultant in the field of securities regulation, specializing in matters involving the trading and sales practices of broker dealers. I am familiar with how securities markets operate (e.g. the various types of Exchange and OTC markets, the role of specialists and market makers, how securities prices are determined and how to detect manipulated or noncompetitive markets).

I am currently providing consulting and litigation support services to broker dealers and attorneys. I have been retained as an expert witness in numerous cases involving underwriting and trading in the securities market. I have testified in federal court, as a retained expert, on six occasions; once for the SEC as an expert in market manipulation (SEC v. Andrew S. Pitt, et al.), twice for the U. S. Attorney's office, and three times as an expert for private attorneys.

II. Engagement with Litigation/Compensation

On April 29, 1999, I was engaged by the plaintiff to analyze the trading activity in Hemispherx Biopharma Inc. ("HBI") beginning on July 1, 1998 ("trading period"). I was asked to render an expert opinion on whether the trading activity and the price of HBI stock was the product of 1) the free economic forces of supply and demand, or 2) the manipulative short selling and defamatory statements by defendants and others. Charges for my services are based on an hourly rate of \$200 for research, report preparation, trading analysis, testimony and depositions.¹

In connection with this case, I performed an examination of the trading records of more than 25 broker dealers which traded in HBI common stock for the review period (i.e., order tickets, blue sheets, customer and broker dealer account statements), records of the American Stock Exchange ("AMEX") and other Exchanges, records of the

¹ The hourly rate decreases to \$150 per hour for all hours billed in excess of 200 hours.

National Securities Clearing Corporation ("NSCC"), Plaintiff's Second Amended and Supplemented Complaint, ACI press releases, depositions listed on Appendix A, price and volume reports, HBI news articles, HBI's filings with the SEC, and reports concerning securities location and affirmative determination.

My examination was designed to identify and, if found, to assess the impact of 1) naked short selling (i.e., were HBI shares sold by sellers who did not own the security and could not deliver the security to the purchaser by the settlement date) and 2) trading ahead of research reports. The opinions expressed in this report are based upon my review of the referenced data, my review of the trading records, and the conclusions I draw from: 1) trading patterns; and 2) the actions of defendants in connection with HBI trading.² These opinions are based on a reasonable degree of certainty in the field of securities regulation and securities industry customs and practices.

IV. Opinion

General overview of the securities markets

The price of a security is determined by the free economic forces of supply and demand. When the demand for a security is greater than the supply, the price of the security will generally rise; when the demand of a security is less than the supply, the price of the security will generally decline. HBI is listed and traded on the AMEX; buy and sell orders are directed to the floor of the AMEX and executed by the AMEX specialist. The specialist is a person assigned by the AMEX to execute orders. The vast majority of HBI trades were executed on the AMEX floor.

General overview of short selling

In general, a short sale occurs when a broker dealer or customer sells a security which is not owned by the seller. My examination in this case tested whether broker dealers, including ACI, complied with the SEC and NASD short sale rules.³ For a broker

² My opinions are based on documents and deposition testimony I have reviewed to date. My opinions are subject to change based on my review of any supplemental documents and testimony received after the date of this report. If requested, I will update this report.

³ Rule 10a-1 under the Securities Exchange Act of 1934 and Rules 3350 and 3370 under the NASD Rules of Fair Practice.

dealer to effect a short sale, it must sell at or above the last reported sales transaction price, and make an affirmative determination that it can borrow the security or otherwise effect delivery by settlement date.⁴ The NASD's affirmative determination rule is designed to ensure the settlement of short sale transactions and to prevent short sellers from selling an unlimited supply of a security into the market (i.e., over supplying the market). If broker dealers do not comply with the short sale rules, the illegal short selling alters the economic forces of supply and demand by creating an over supply of stock in the market, and dilutes the value of the shares in the public float.

Disclosure

The securities laws require full disclosure to investors. When disclosures about companies are made to the market place, investors rely on this information to decide whether to buy or sell securities. Fraudulent statements or omissions about a company adversely affect the economic forces of supply and demand. These statements may cause the price of a security to rise or fall based on fraudulent information, and not on competitive market factors.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder (the "anti-fraud provisions") prohibit individuals from 1) employing any device, scheme or artifice to defraud and 2) making untrue statements of a material fact. The anti-fraud provisions include in the definition of fraudulent activity "...[m]aking any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading". Generally, the definition of material is interpreted as something that would be important to a reasonable investor in deciding whether to buy or sell a security.

ACI's "Naked" Short Selling

My review of ACI's activities found that between August 28, 1998 and September 17, 1998, ACI sold short more than 130,000 HBI shares into the market for its own accounts and the accounts of its customers. ACI did not deliver any of these shares to its

⁴ This requirement does not apply to a bona fide market maker, an exception which is not applicable for Exchange-traded securities.

clearing broker dealer, Spear Leeds and Kellogg ("SILK"). SILK produced records that demonstrated it was not contacted by ACI to borrow HBI shares during this period, and it did not lend any HBI shares to ACI. SILK has no record that it made any affirmative determinations on Asensio's behalf for its short sales. However, ACI stamped on a photocopy of each ticket it produced in this Case that it made an affirmative determination it could borrow the securities.

It is my opinion that the stamps on the photocopies of order tickets are not reliable evidence that ACI made affirmative determinations. My review of the copies of order tickets produced by defendants reflect that the "affirmative determination made" legend was stamped on the copies rather on the original order tickets. There was no testimony to establish when these "tickets" were stamped, who made the affirmative determination, or who was contacted. One employee, Chehrazad Mamri testified that she wrote the words "affirmative determination made" or "okay to borrow" on the original order tickets but she could not testify when those notations were placed on the order tickets. She also testified that Asensio directed her to make these notations sometime after the trades had been placed and that she was never involved in contacting any broker dealer to make such affirmative determinations. The original order tickets produced for inspection in the course of this litigation did not have any affirmative determination stamps on them. Another employee, Charles Stewart, testified in his deposition that the order tickets were not stamped on the day of the trade, and that the copies of the order tickets were stamped sometime after the date on which the trades were actually made, and could have been stamped after the Complaint in this action was filed.

In contrast to ASI's order tickets, other broker dealers testified that HBI stock was impossible to borrow during this same period. One individual, Robert Brunson (Bear Stearns), testified that Bear Stearns could not locate any HBI shares between the end of August and early October 1998. He also testified that if Bear Stearns could not locate any HBI shares, he did not believe any other firm could do so during the same time period. Individuals from two other broker dealers (Goldman Sachs and SILK) testified that HBI stock was on their "hard to borrow" or "impossible to borrow" lists during this period.

It is my opinion that ACI's short sales for its own accounts and the accounts of its customers violated Rule 3370 of the NASD's Rules of Fair Practice and that ACI knew these short sales were "naked" (i.e., it did not have a reasonable basis to believe it could

deliver the securities it was selling to SILK, its clearing broker dealer, by settlement date). In August 1998, SILK had an open short position consistently between 120,000 and 300,000 HBI shares. In September 1998, SILK's open short position grew to between 400,000 and 600,000 HBI shares. It is my opinion that these open short positions included the open short sales by ACI and its customers. ACI has not produced any evidence that HBI securities were, in fact delivered to SILK for clearing on settlement date.

"Naked" Short Selling by Others

My examination found naked short selling activity by two other groups of investors: 1) customers of ACI who sold short in accounts maintained at other broker dealers; and 2) customers who sold short in accounts maintained at Canadian broker dealers.⁵

The first group of short sellers (West Highland Partners, Andrea Lakian, Blue Ridge and Quilcap), had accounts both with ACI and other broker dealers although most of the trades were executed at the other broker dealers. I noted from testimony that each account had contacts with Asensio during the trading period. Andrea Lakian is the wife of John Lakian of Fort Hill Group, which leases and shares office space with ACI. Judy Stone (Quilcap), John Griffen (Blue Ridge) and Mike Wilkins (West Highland) were also personal acquaintances of Asensio.

The second group of short sellers (Bulldog, Steven Schechter and Paulson Partners) sold short substantial quantities of ACI shares through two Canadian broker dealers, Thomson Kernaghan and First Marathon. The short selling at the Canadian broker dealers is noteworthy because the U.S. broker dealers who executed the short sales for the Canadian broker dealers had no documentation that affirmative determinations had been made by them or the Canadian broker dealers. It does not appear that any of the shares sold by this group of short sellers were, in fact, delivered because both Thomson Kernaghan and First Marathon had deficits at NSCC consistent with the short selling volume.⁶ It is my opinion that these short sales were "naked" and that the short sellers

⁵ A chart of these short sellers is attached as Exhibit B.

⁶ A chart detailing daily short positions at NSCC for these broker dealers is attached to this report as Exhibit C (*note: Appendix C was not available to reproduce here*).

did not have a reasonable basis to believe they could deliver the HBI shares to the clearing broker dealer by settlement date.

"Naked" Short Selling and ACT's Negative Statements Impacted Price of HBI shares

On August 28, 1998, ACI and the two groups of short sellers had a combined short position in excess of 390,000 HBI shares. The short positions for these investors grew to more than 865,000 HBI shares by September 17, 1998.⁷ The period between August 28 and September 17, 1998 is noteworthy because the market price for HBI shares remained strong despite the substantial short selling by ACI and these groups of investors. In fact, the price of HBI shares closed higher on September 17, 1998 (\$9.625) than it did on August 28, 1998 (\$8.50) and traded as high as \$13.1875 on September 9, 1998.

It is my opinion that the demand for ACI shares was strong enough to sustain the price of HBI shares despite the illegal "naked" short selling by ACI and others until ACI made negative statements about HBI to the public in the form of a Business Week article that was first disseminated on the evening of September 17, 1998. Once this article was disseminated to public investors, the price of HBI shares dropped dramatically from \$9.625 on September 17 to \$5.25 on September 22, 1998. It is my opinion that the statements attributed to Asensio in the Business Week article would be subject to the anti-fraud provisions discussed above. As a result of its activities, ACI was in a position to benefit financially because it established a short trading position prior to releasing the negative statements about HBI.

Trading Ahead of Research Reports

In November 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") which requires all broker dealers to "establish, maintain and enforce written procedures reasonably designed" to prevent, among other things, the misuse of proprietary research and research reports by employee and proprietary accounts (they are referred to in the securities industry as "Chinese wall"

⁷ ACI's initial short sale was executed on August 28, 1998.

procedures). ITSFEA also granted the Securities and Exchange Commission rule-making authority concerning these "Chinese wall" procedures. The SEC decided it would be best to rely on the NASD and the New York Stock Exchange ("NYSE") to establish minimum standards for broker dealers to comply with these procedures. The NASD and NYSE adopted rules governing the implementation of "Chinese wall" procedures.

Each broker dealer was required to establish policies and procedures reasonably designed to prevent the misuse of inside information considering the broker dealer's business, structure, size and other relevant factors. The intention to issue, update or downgrade a research recommendation was to be covered by these procedures. Such information could not be disclosed, prior to public dissemination, to anyone outside the Research Department (and in some instances to some within the Research Department) unless there is a need to know the information.

NASD rules governing just and equitable principals of trade prohibit its members from trading ahead of research reports. Specifically, the NASD rules prohibit a broker dealer from engaging in trading activity that purposefully affects the broker dealer's proprietary inventory position in a security in anticipation of the issuance of a research report.

ACI Traded Ahead of its "Research Reports"

As previously noted, during the three weeks prior to the Business Week article, defendants took substantial "naked" short positions totaling more than 130,000 HBI shares. Of particular note, on September 17, 1998 (just prior to the release of the Business Week article), one ACI employee, Chehrazad Mamri sold short 750 HBI shares, and ACI sold short 10,000 HBI shares. Additionally, John Paulson, a close friend of Asensio, sold short 135,000 HBI shares on September 17, 1998. After the Business Week article was disseminated, the price of HBI declined and ACI was able to cover its short sales at a profit.

It is my opinion that the trading activity of defendants ACI and Asensio immediately prior to releasing a research report (i.e., the Business Week article) violated the provisions of ITSFEA, which requires a "Chinese wall" between a firm's research department and its trading department and prohibits trading ahead of the dissemination of

research reports. Asensio was the person who made all of the trading decisions on behalf of ACI and Asensio was the person who researched the companies ACI covered.

Disciplinary Proceeding

The NASD initiated enforcement proceedings against ACI and Asensio alleging violations of the NASD Rules of Fair Practice which occurred during the period covered by the HBI short selling:

- 1) Violation of NASD Rule 3570 - During the period from August 1, 1998 through July 31, 1999, ACI failed to keep written records of affirmative determinations in connection with 306 transactions in which the firm sold securities short for its own account or the accounts of its customers. With respect to 117 transactions, ACI failed to make affirmative determinations. In addition, 18 order tickets indicated that an affirmative determination had been made, but ACI had no record of any person or entity allegedly contacted in connection with the determination;
- 2) Violations of Rule 2110 and Marketplace Rule 6130 - During the period from August 1, 1998 to July 31, 1999, ACI reported 331 sale transactions to NASDAQ's Automated Confirmation Transaction Service ("ACT") without indicating that they were short sales.

ACI and Asensio settled these proceedings by signing an Acceptance, Waiver and Consent Letter ("AWC") on October 20, 2000 which was accepted by NASD Regulation ("NASDR") on November 13, 2000. The submission of the AWC by ACI and Asensio was made voluntarily and made with the understanding that the AWC would become part of ACI's and Asensio's permanent disciplinary records when it was accepted by NASDR.⁸ NASDR Rules and the AWC prohibit Asensio from denying any allegation contained in the AWC once ACI and Asensio signed the AWC, and it was accepted by NASDR.

I noted that the time period covered by the NASDR action included the time period that ACI was short selling HBI stock (i.e., August through October 1998). In

⁸ The AWC would be considered in any future actions brought by the NASDR and would be made available through the NASDR's disclosure program in response to public inquiries about disciplinary records.

addition, the violations noted in the AWC are consistent with my opinion that ACI's affirmative determination notations on the order tickets were not reliable, and that ACI was not making affirmative determinations that it could locate and deliver HBI shares to its clearing broker dealer to settle its short sales. Moreover, since the AWC indicates that ACI was not disclosing its short sales to the market, it is reasonable to believe that ACI did not disclose its HBI short sales to SILK, so that SILK could make affirmative determinations.

Exhibit A

List of Depositions Reviewed

Charles Stewart	Asensio and Co
James Nardi	Sharpe Capital
Kurt Switala	Sharpe Capital
John Miniio	Spear Leeds
Lisa Butler	Spear Leeds
Robert Brunson	Bear Stearns
Jeff Capretta	Bear Stearns
Mark Klaum	Goldman Sachs
Thomas Gooley	Goldman Sachs
Kathy LaColla	US Clearing
Ron Pollack	Bulldog Partners
Manuel Asensio	Asensio and Co

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Exhibit B

Hemispherx v. Asensio

Total Short Sale Positions

ACI Accounts	28-Aug-98	17-Sep-98
Asensio & Co	3,000	95,500
Asensio Capital Mgmt	0	15,000
Andrea Lakian	0	10,000
James Peacock	0	750
Chehrazad Mamri	0	750
Stephen Kessler	0	8,500
Total ACI Trades	3,000	130,500
ACI Customers		
Trades w/ Other BD's		
Andrea Lakian	0	4,000
West Highland Capital	185,900	185,900
Quilcap	113,800	120,400
Blue Ridge	0	90,000
Total ACI Customers	299,700	400,300
Canadian Accounts		
Bulldog	73,800	119,800
Schacter	15,000	80,000
Paulson Partners	0	135,000
Total Canadian Trades	88,800	334,800
Grand Total	391,500	865,600