July 30, 2008

Securities and Exchange Commission
100F Street NE
Washington, DC

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Mr. Chairman,

I have enjoyed witnessing these past few weeks whereby Wall Street members clash with their biggest clients over what is necessary and what is not necessary in the regulation of our capital markets. Most amusing in all of this is the rhetoric displayed that is focused squarely on costs of protecting our capital markets and public companies.

I must ask; what cost is there to the general public who invests in these targeted public companies and how does this impact our overall US Economy? I for one would think that destroying the savings portfolio's of the average US Investor could have serious impacts on their ability to re-invest in the economy. In the political circles of Congress we call this a 'negative' stimulus package that translates all the way down to lower taxes being paid.

Yesterday you extended this order for these financial firms once more citing this to be the last time. In the reports out it is disclosed that:

*"Groups representing hedge funds, many of which are short-sellers, have been lobbying against any broadening of the rule to the rest of the market. Some argue that it would make it more difficult, expensive and risky to sell shares short."*

Such blame is being reportedly due to the manual process of formalizing a pre-borrow where the normal process of a short sale via the locate and short sale execution are 'computer generated program trades'.

Consider carefully what is being expressed and exposed here and you have your answer as to why the hedge funds are pushing back as hard as they are.

**Normal Short Sale Process (All Cylinders Working):**

Hedge Fund A determines that Company I is overvalued and decides to take a short interest in the stock. The Fund goes into the market, identifies a locate and Executes the trade through Broker-Dealer 1. Broker-Dealer one obtains a stock borrow on Day 3 and settles the trade.

This fund holds this short position for some indeterminate period in time. The fund carries the cost to borrow throughout the short interest period starting at T+3.

**Normal Short Sale Process (Speed Bump):**

Hedge Fund A determines that Company I is overvalued and decides to take a short interest in the stock. The Fund goes into the market, identifies a locate and Executes the trade through Broker-Dealer 1. Broker-Dealer fails the borrow because no shares are presently available. The broker-engages in some manner of settlement with no sense of urgency or demand from regulators or the receiving firm due shares.

This fund holds this short position for some indeterminate period in time. The fund carries the cost to borrow throughout the short interest period starting at T+3 regardless of when the trade actually settles.

**<u>Normal Short Sale Process (Pre-Borrow):</u>**

Hedge Fund A determines that Company I is overvalued and decides to take a short interest in the stock. The Fund goes into the market, identifies a share to borrow and executes the trade through Broker-Dealer 1.

This fund holds this short position for some indeterminate period in time. The fund carries the cost to borrow throughout the short interest period starting at Trade instead of T+3. The additional cost to this short seller over the locate only trade scenario is the additional days to borrow between trade and T+3.

For an investor choosing to take a short interest position in a company this cost is negligible considering the already expected duration of carrying that borrow.

**<u>Rapid Trading Short Sale Process (Locate Only):</u>**

In this case the computer program created by Hedge Fund A has identified short target Company I and initiates the short sale process. The requirement for locate may be met or, the order may be split between Broker-Dealer I, II, III, etc… in order to use the same locate for multiple trade orders. This investor has no intent on making a committed investment and is looking for smaller profits derived that same day.

The short sales are executed into the market in rapid succession taking out any buy side demands and aiding in the collapse of the market. Under the duress of the selling the Hedge Fund is covering the short sales executed for profit. This process can be repeated multiple times a day or over a period of days.

The goal under this trading scheme is to profit on the volatility without care what the stock price trades. There is never an intent to settle because the trade is expected to be covered within the settlement period making the trade account net flat.

Because the trade is covered within the T+3 settlement window there is no requirement to borrow a stock and thus no fee is applied in the cost of the trade for the stock borrow. With the only requirement being a stock locate, a savvy fund can use the same locate to trade in and out of positions all day using the "naked short" as a leverage to instill fear.

**<u>Rapid Trading Short Sale Process (Pre-Borrow):</u>**

This is where the hedge funds are concerned.

Under this scenario, the computer generated trade must be slowed by the requirement of a pre-borrow and that pre-borrow attached to a singular trade executed. This scenario restricts the seller from using the same locate of shares for the execution of multiple short sale orders through multiple broker-dealers and through multiple trade cycles in any given day.

A cost is applied to this right to short a stock because the short seller must carry the borrow fee for a single day. This is a cost that short sellers do not want to carry and a cost that they now fight over.

For the SEC to cave on this argument they are essentially providing these rapid trading short sellers, these computer generated program funds to naked short the market in a manner similar to market making but without the requirements to maintain orderly markets. These investors are not creating order but chaos with the sole intent on profiting from the chaos created.

Large funds with excess capital can crush markets to achieve profit using whatever capital is necessary to move the market to profitability.

Under Rules 15c3-3 and 15c6-1 all trades must be made with the intent of settlement. Day trading short sellers and rapid trading short sellers have admitted that they have no intent on settling the trade executed, their intent is closing the trade within the settlement window and thus worry not about what is being sold.

In the 19 stocks that were put under emergency protection, the level of short selling in those stocks went down dramatically. But those markets had ample shares available to short.

I contend that the reason the short volume decreased was due to the unwillingness of the rapid trader to carry the burdens of a borrow in the cost of their trade.

These short term speculators are not the type investors we should be risking our capital markets for. We should not risk the safety of our markets, the safety of public companies and their abilities to operate and raise capital, or the safety of the US working class investor so that some large hedge fund using the firepower of wealthy individuals can make higher profits cheaper.

Mr. Chairman, we are in the age of technology. Computers transfer data in nanoseconds and our nation has created a central depository for stock holdings. The creation of a rule that requires a pre-borrow to insure that all present laws are being complied with is a small task to administer when you consider the alternatives. No short seller should be granted opportunity for a riskless trade and an opportunity to trade without the normalized fees associated with that trade. A short seller must pay for that right to sell short by paying for the share used to execute that trade.

What the public is privy to see is the net settlement results that represents the conclusion to 6.5 hours of trading activity. We see the net settlement of a day's trade and not intraday snapshots of what is being bought and sold relative to a real share vs. an imaginary one. We see this information in a delay of once per quarter, delayed a quarter. Short sales are only published twice a month and again only represent the net open positions.

Regulators such as the SEC and SRO's have access to additional data that identifies the total levels of short sale activities throughout the course of the day as a total percentage of total trade volume. Regulators have real-time access to how much of these short sales are nothing more than rapid trading events profiting on the impacts such trades have to the market.

I believe that it was this type trading that raised concerns with the staff and which created this emergency order. It is now time to act upon the reality of what you know and make the pre-borrow permanent law.

Dave Patch

In an optimal world:

1. All short sales would require a pre-borrow. The pre-borrow would insure that clients do not deceive brokers and day traders do not cheat the system. This would eliminate much of the gaming taking place today by short sellers and broker-dealers.

2. Trade settlement would be reduced to T+1 to lower the opportunity for present day non-transparent fraud. The CNS system will be less spongy. The closer settlement is to trade the smaller the impact an event can have on the overall market.

3. Market making would maintain their present exemptions for liquidity but there would be limits on where they can use such exemptions. There would be a cap on when the market maker adds liquidity in a buy-side or sell-side event. For example, in a $10.00 stock a market maker is excluded from using the market making exemption once that market falls into a 5% loss on the day. They are likewise not to make a market making purchase when a stock appreciates more than 5% in a single day. Markets trading in outside this range already have sentiment in them and any buyer or seller wishing to enter must find an equal trade on the other side. This may lower overall volume as it slows down trading but it will also protect against abuses we know exist by those with the exemptions. The exemption limits would be based on the market itself in the same manner that minimum posted shares is modified based on price. When a stock is falling there is no need to make a bona fide sell into the fall. Similarly when a stock is rising there is no need to buy into a rising market further pumping the stock. Market making is by definition the contrarian to market direction.

4. After a settlement failure has exceeded T+TBD a mandatory buy-in is executed by an independent third party to the trade. I would suggest this be the DTCC although they are a conflicted third party. The third party would be mandated to execute the buy-in as a guaranteed delivery and at the cost required for guaranteed delivery. This will eliminate the present regulations that simply require best efforts that are too arbitrary to enforce. This guaranteed buy-in would include market making activity.

5. Short sales are released at the end of each business day relative to total trade volume. This will provide the market investors with full transparency on why markets are moving as they are and who is moving them.

6. Regulations will be addressed in a manner that failure to comply will be closer tied to market manipulation than to mere “compliance” violations. Pre-Borrow is cut and dry, locate but no borrow is arbitrary. Mandatory buy-in is final, best effort is arbitrary.

What the SEC and Congress need to do as they evaluate such options they take is to consider what the risks and rewards are for each involved in the equation. Usually the risks v. rewards diverge depending on whether you are the investor or the system.

Should liquidity for one investor place another investor at significant risk and where is the break point? Should the cost efficiency for one place financial burden on another? There needs to be a compromise in how the markets function but even in compromise the market regulators and Congress must define which is #1 and which is #2. Should growth of capital markets trump investor protection or should investor protection trump capital market growth. Does growing the capital market liquidity supersede the rights of individual investors to a fair market?