

July 22, 2008

Securities and Exchange Commission  
100F Street NE  
Washington, DC

Mr. Chairman & Commission Staff,

It has been a long 8+ years of my life spent trying to educate you on the destruction of our capital markets by short sale abuses. In this near decade of time spent in the education process I have witnessed the SEC migrate from a position where naked short selling does not exist, to it exists at a very finite level, to naked shorting being a serious and abusive process, and finally to where we are today, and emergency order to protect the most liquid financial institutions from the abuses.

Congratulations on having somebody at the SEC have the light go on upstairs.

Unfortunately that lit is not well lit as many within the agency remained entrenched in the position that short selling is good for the markets at any cost. Short selling provides liquidity and price discovery and thus should not be constrained in any manner.

Those within the agency who continue to believe that short selling should remain unconstrained need to have their employment status re-evaluated. Bear Raids, market manipulation, and the ultimate destruction of technology, jobs, and community stability have all been the negative impacts of an unconstrained investing process.

This reform up for re-submission for public comment has received better than 640 new comments in the past 2 weeks alone. Not one supports any alternative but the complete abolishment of the Options Market making exemption.

If history repeats itself, industry members will submit a few comments on the last days asking that the Commission forgive the rights and opinions of the general investing public and that these exemptions remain intact in order to provide liquidity for the options markets.

Options Market Makers will threaten the Commission with rhetoric about how they can not support their business model without the exemptions. Not one of the memos will contain any evidence or analysis to support such claims. Not one memo will provide evidence that alternative approaches were investigated and found insufficient. Not one will provide the very empirical data that was requested of the SEC and is presently responsible for this delay once again.

Instead the industry will demand the Commission to support their rights to unrestricted revenues at the expense of the investing public, the public companies, and our local communities that house those employed by these companies.

Despite the public comment, private communications continue to exist between the commission and industry lobbyists. The Securities Industry and Financial Markets Association (SIFMA) lobbying on behalf of Wall Street and the Managed Fund Association (MFA) lobbying on behalf of short selling hedge funds used their political connections to address the Commission in private.

Fortunately not all stays private and the public is exposed to a glimpse of how conflicted such meetings and communications can become.

Former Congressman Richard Baker, now CEO of the MFA along with short seller James Chanos drafted a memo to Chairman Cox, likewise a former Congressman hoping that the political connections of Congress can persuade an outcome beneficial to his clients – Wealthy Hedge Fund Managers.

It is the "political juice" connection all over again.

The memo however portrays appearances that go well beyond that of conflict of interest, this memo actually illustrates the expectation of separate rule making for hedge fund investors and illustrates the very fraud I have lobbied against these past 8+ years. I will highlight some of the admissions herein:

Although the stated purpose of the Emergency Order is to prevent naked short sales, the Emergency Order will have the effect of discouraging legitimate short sales. Of course, there are always those participants who only support free markets when they ascend and then prefer intervention during price corrections and a return to more rational values. Moreover, the temptation remains for corporate management teams to blame unidentified conspiracies and short selling rules as the cause of poor stock performance, rather than acknowledge poor fundamentals, and in some cases, the impact of their own poor risk management and business and investment decisions. Unfortunately, the Emergency Order gives more comfort to those who fall into that camp than it does to the thousands of market professionals who provide the market with its fundamental transparency and integrity.

Mr. Chairman, the emergency order enacted by the Commission simply forces the investing public to guarantee that in the execution of a short sale such trade will meet the full intent of Rules 15c3-3 and 15c6-1. These rules require that no trade be executed without the express intent to settle within 3-days. To any short seller who must execute a pre-borrow this will insure that such will happen.

Unfortunately, instead of addressing the commitment to settle Chanos and Baker blame the corporate officers for their right and expectation to a fraud free trading environment. How can a market have fundamental transparency and integrity when the short selling activities taking place are not published daily or real time but instead delayed and infrequent?

The best markets are those that are efficient -- where buyers and sellers interact to express their views and ultimately arrive at the price for a given company's shares, and not where one group of market participants may be hampered by overly burdensome and unnecessary regulatory provisions. Restrictions on short sales distort the fundamentals that drive fair market prices and are, in the long run, counter-productive because they remove liquidity and healthy skepticism from the marketplace.

Daily publication of short interest levels would allow long investors to adjust their positions based on the transparency of whether a selloff was short sale induced or long sale induced would create such interaction but does not happen. Short sellers do not want their interest made public. A short seller participating in this market has full visibility on how their individual investments impact a market but the long investor is unaware of the mechanics to such a selloff. Likewise, transparency of short sale activity relative to settlement activity is not real time but delayed months; well after a market cycle has taken place.

The expansion of the Emergency Order to stocks that are less liquid than the Designated Securities would undermine critical market activities. The most direct impact of the Emergency Order is to make it more difficult, expensive, and risky to sell short. Under the Emergency Order, before undertaking a short selling strategy, a market participant must consider in advance the costs and risks of ensuring with 100 percent certainty that enough shares will be available to cover the maximum number of shares that may be sold short throughout the duration of the strategy. Moreover, the market participant must compete for suddenly scarce stock borrow with all of the other market participants who are conservatively borrowing substantial amounts of stock to avoid any risk of violating the rule, and with market participants who can easily squeeze shorts by pulling scarce stock borrow from the market.

Mr. Chairman, this section of dialogue by Chanos and Baker illustrate fully the expectation by each that a short sale does not have to settle properly. I contend that this opinion is not limited to Chanos and Baker but has become standard industry practice despite such being illegal.

Before a short sale is executed every market participant must enter into such transaction with full 100% certainty that the trade will be settled within 3-days. There are no afforded options under the securities laws in meeting 25%, 50%, 75% settlement coverage. The law requires 100% and requires 100% within 3-days. And expectation of failure is a violation of Rules 15c3-3 and 15c6-1. The fact that avoidance of such coverage is based on expense is not an excuse for failure. Certainly excuses regarding expense of trade can not be considered when such funds reap ungodly profits and fund managers are being paid obscene annual compensation.

Expense is all part of the risk factor to trade and no investor whether it be a short seller, long investor, or broker-dealer entering into a bona-fide market has the right to a riskless trade.

The expectation by the industry that a short seller has the right to short at whatever level they choose is inaccurate and if done would not only violate trade rule but could be the very manipulation that we now face under the bear raids before us.

For example, an investor may decide to buy a convertible bond. Convertible bonds are a critical tool available to companies, including distressed companies, seeking to raise capital. Most investors in convertible bonds seek to hedge their market risk by shorting stock to maintain a sufficient "delta" hedge. Operating under the rules of the Emergency Order, a potential convertible bond investor, must not only price the cost of selling short on day one, in a highly stressed and distorted stock borrow market, but must price this cost for the entire duration of the expected holding period for the convertible bond. The stock borrow must be maintained for the entire duration of any short position, and additional short sales must be effected to maintain an appropriate delta hedge as the stock price moves. In this scenario, potential convertible bond investors may refrain from investing and leave distressed companies without an important source of capital.

Again this commentary alludes to much more than where Chanos and the MFA want to go regarding short sale regulation but where they presently stand in trade today.

No short seller has the right to enter into a trade without the express intent on trade settlement throughout the duration of a short position. Choosing to enter into a convertible bond investment is the right of any investor and which such right come risk. This memo implies that such risks are presently being hedged through the short sale process where some or the entire sale does not settle due to a cost to borrow expense.

Dialogue such as this is an admission of fraud by those who engage in such activities. Trade risk and cost of trade are not an excuse to fail in meeting the obligations of a trade contract.

The memo presented by James Chanos and Richard Baker is a threat against the agency. The memo never quantifies what additional cost would be incurred or has been incurred since the emergency order was imposed. Likewise, the memo never substantiates what capital investment levels would dry up if investors found it difficult to short hedge such investment. Theoretically, unless the company is on a hard to borrow list such commentary is trivial.

In the end I find this memo by Chanos and Baker to be extremely enlightening and extremely dangerous at the same time.

I am enlightened in the fact that the opinions and preferential expectations of the short seller are now public and available in black and white. That this investor class has found solace in that these markets are here for their personal pleasure and that there are no laws to abide by when such laws find way to create the burdens of expense to their bottom line.

The danger in this memo is that it was drafted by a former US Congressman and Chairman of the House Financial Services with oversight over our Capital markets. That this former Congressman has outlined how and why naked shorting takes place and does not grasp what impact such has on the millions of investors and thousands of public companies that put faith in the safety of these public markets.

How many more are out there with this thought process.

We thank you for this opportunity to provide our thoughts. We ask the Commission to carefully consider our suggestions, and we would be happy to discuss them at any time.

Sincerely,



James S. Chanos  
Chairman  
Coalition of Private Investment Companies



Richard H. Baker  
President and Chief Executive Officer  
Managed Funds Association

Mr. Chairman, the memo delivered is an admission that fraud takes place in our capital markets and that failure to settle trades is a strategic component to that. The memo rationalizes why short sales should be unconstrained and that the cost of settlement is of lower significance to the short sale execution itself.

I urge the Commission enforcement staff to initiate a sweeping investigation into the types of trading activities addressed in the memo looking for the blatant failure to properly locate, borrow, and settle trades as required by law. Since Mr. Chanos is an author to such memo I would urge that his fund be one of the first under investigation.

“How Much Fraud are you Willing to Accept for Liquidity” William Donaldson before Congress 2004

David Patch