January 1, 2007

Nancy Morris
Secretary
Securities and Exchange Commission
Washington, DC

RE: Amendments to Regulation SHO [Release No. 34-54891 File No. S7-21-06]

Ms. Morris, Commissioners,

For many years investors and market professionals have addressed the ease in which the tick test could be manipulated. With the sale of a few shares the market could be moved to an uptick only to be trampled by a much larger sell order into the bid. With all of this open communication the commission failed to react and investors paid the price. Today, in response to such activities, the Commission now proposes to eliminate altogether the uptick test.

From a simplistic view the answer is simple. Why not eliminate the tick test since it was being manipulated while it existed. But with that being said, the fact that it was being manipulated while in place the Commissions analysis by the OEA and thus this proposal is hardly sufficient in addressing the real concerns the tick test was to address – Bear Raids.

Consider this comment published within the Commission's presentation of material***: "In addition, the Pilot data did not provide any indication that there is an association between manipulative short selling, such as "bear raids," and price test restrictions on short selling."***

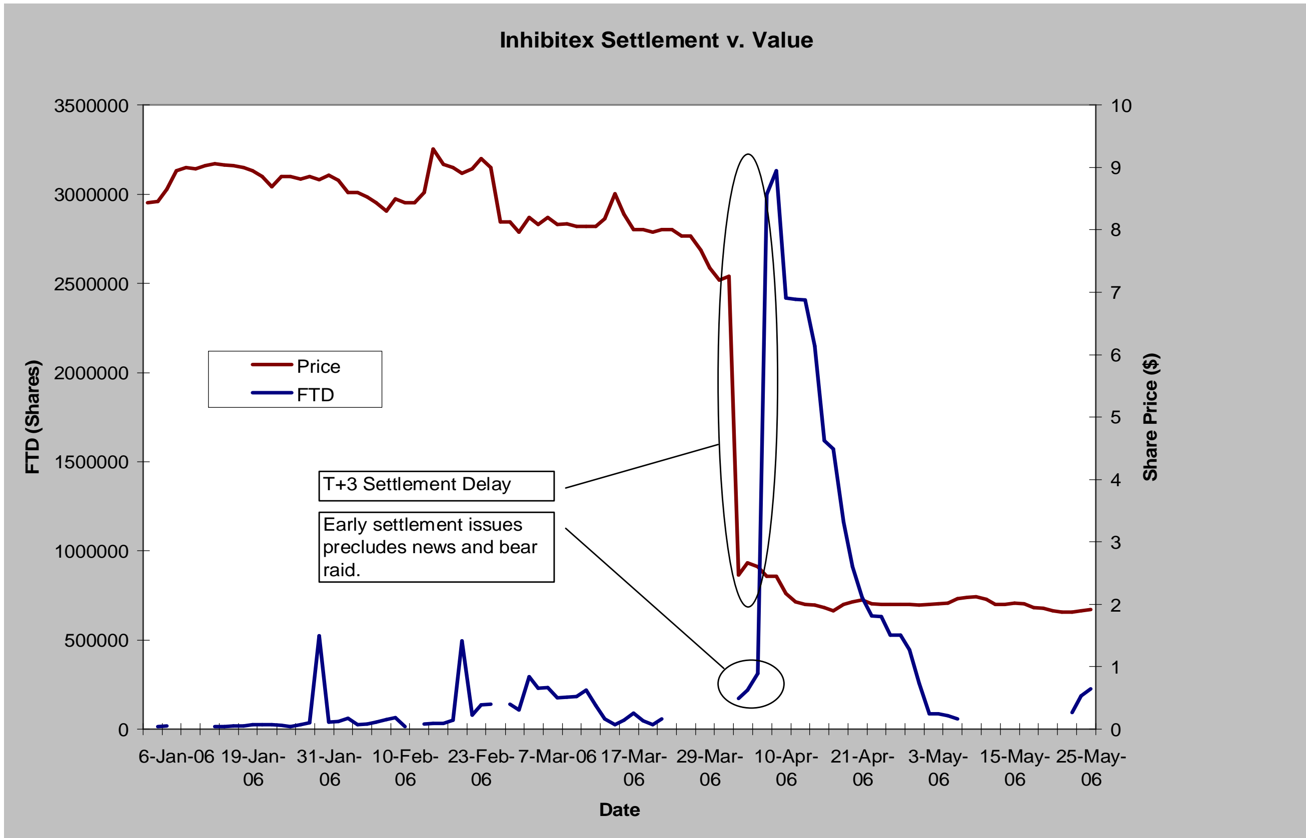
I would first request the Commission to provide evidence that it has a qualified understanding of manipulative short selling. To date, the Commission has taken a rather small interest in investigating and seeking out enforcement in manipulative short selling schemes while several Commissioners believe at this time a "Bear Raid" can no longer exist.

For the record, Bear Raids continue to exist using a wide range of trading strategies, all of which the Commission has apparently overlooked. Bear Raids do not require a stock to fall to near death but can be restricted to short intervals of time and quick profiting by the short seller.

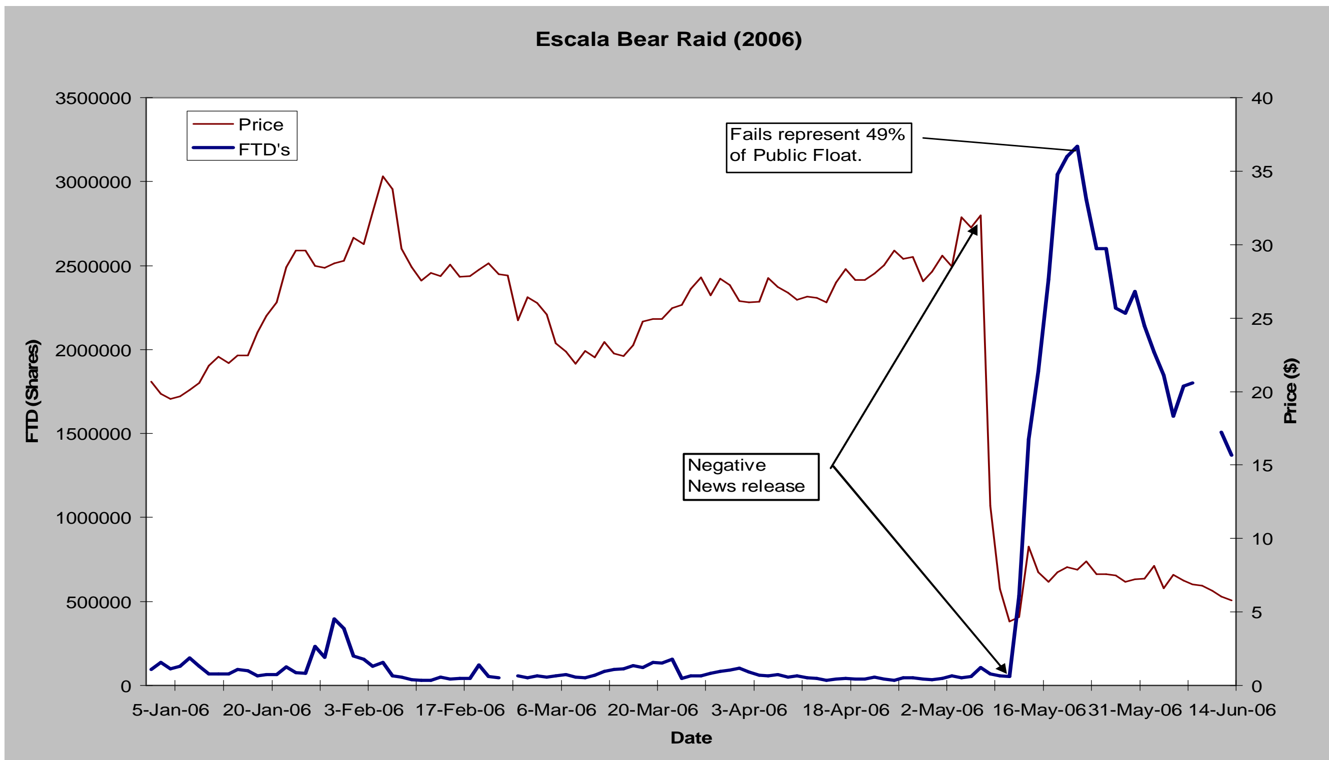
For example, using data supplied by the Commission under the Freedom of Information Act, several bear raids appeared to have taken place in which large quantities of trades took place in a localized window of time resulting in a massive settlement failures. Companies such as Vonage, Escala Group, Inhibitex Inc., all experienced a precipitous drop in share value while watching the short sales, and the level of settlement failures by those short sales, skyrocket during that same window of time.

In the case of Inhibitex (NASDAQ: INHX), the stock closed at $7.39 on March 29, 2006 and carried a Continuous Net Settlement (CNS) failure position of 172 thousand shares. But a mere 3 trade days later the stock was closing at $2.45 and a CNS failure position of over 3 Million shares. The stock was being smothered with short interest selling as the stock dropped 66% in 3 trading days and while the settlement failures increased 1700%

A Chart of the Inhibitex bear raid is illustrated below:



This same scenario is evident with Escala Group (NASDAQ: ESCL) as the stock closed on May 6, 2006 at $32.00/share to close 3 days later at $4.34. And like Inhibitex, Escala's CNS failure position grew as the stock plummeted growing from a position of 52 thousand shares to 1.87 Million shares and 3 days later to over 3 Million shares.



In the case of Escala, a negative news release created the sudden decline but, in the spirit of a bear raid, the negative news was exacerbated by massive selling into the news creating a panic sell off. The settlement failures for the first day representing nearly 10% of the total trade volume on the day not considering how much of that additional volume was market making washed trades and short selling.

For the record, the negative news that created the raid was later refuted by the company. The stocks recovery being a mere fraction of its decline as is typical in such raids.

In the case of Vonage, the NYSE and Commission are reportedly investigating the massive short selling at the IPO that created a massive selloff in the security. Vonage opened its public offering at $17/share and closed the day at $14.85 under massive short selling interest in trade volume.

These are mere examples of what investors see on a regular basis and are examples the commission must consider as new rule-making is being made.

Did the tick test protect these companies from a Bear Raid? No.
Will eliminating the tick test have any impact on these manipulations? No.

But does the SEC have a program in place to prevent e\vents such as these in the future? The most concerning answer is here because this answer is equally a resounding no.

Consider this comment in the SEC proposal ***"With respect to intraday volatility, OEA found that there was an increase in volatility in smaller securities and a decline in volatility in larger securities in the absence of price tests. This evidence was much weaker for Nasdaq Global Market securities than listed securities….While the majority of results do not suggest that removing price test restrictions would harm small securities, this volatility result is a potential concern."***

In past reforms the Commission has addressed volatility as a bad thing and in fact, in the defining of a grandfather clause in Regulation SHO, the rule now up for reconsideration, the Commission created such a clause to prevent short squeeze volatility citing it as a bad thing. This same Commission is now identifying that the elimination of this tick test will increase volatility.

If the Commission can create a grandfather clause to eliminate volatility (protecting short sellers), how can this same group create a separate law that increases volatility (assisting short sellers)? This appearance of placing the minority short seller rights above that of the larger investing public is concerning. Certainly placing greater volatility risks in the smaller, less capitalized companies who use their shares to raise capital should be major concerns for the Commission as our economy relies heavily on the employment growth these companies provides our nation.

Of equal concern to this new proposal is that of the Commissions Roundtable conference on this subject and the panelists chosen to speak on its behalf.

Each panelist that spoke as part of this roundtable came in with a prejudice favoring the short seller with panelists such as Yale Professor Owen Lamont being a short selling mouthpiece now on leave from Yale to work for a short selling fund as defined in the SEC bio for Mr. Lamont. Mr. Lamont has also published a significant number of articles each supporting the short seller and their role in our Capital markets.

The panelists were lop sided in their opinions making it impossible to gather a true understanding of the impacts this reform will present to the public. The Division of Market Regulation appeared incapable or

disinterested in creating a panelist debate that would have openly raised the issues from both sides for the public to consider. Laws require open debates not a stacked deck of opinions.

Yet even with such bias, some areas of caution were presented by the panel.

While few will argue that short selling is a necessary vehicle in maintain pricing controls in the market, unrestricted short selling serves no value. Unrestricted short selling is the vehicle of bear raids yet each panelist, one by one, denied the very existence of such activities.

By denying the existence of a bear raid the overall analysis of the panelist must be fully evaluated as evidenced by the major omissions in such analysis.

Consider that our markets are comprised of sophisticated and unsophisticated investors; caution must be placed on protecting the unsophisticated investor from being mentally manipulated by the sophisticated. Short selling is an easy means of such mental manipulation.

As illustrated in the examples above, unrestrained short selling in a declining market will create a panic to the unsophisticated investor driving them to sell off in fear exacerbating the magnitude of the ultimate collapse. The advantage to the short seller exploding under such conditions where panic sets into a market.

So how does the Commission fix the problem?

1. The Commission must put short selling restraints on a collapsing security.
2. The Commission must have very tough and clear guidelines on the settlement of short sales in a collapsing security. By allowing the market to trade into massive settlement failures during a price collapse is allowing a raid, no matter how short, to exist at the expense of the investor. The locate rule must be tightened to eliminate multiple use of a common locate and force the borrow on that locate once a short is executed. By leaving the locate opportunity in the market more shorting, and thus more long victims, are created.
3. The Commission must put strict guidelines on market makers and specialists who make a market in our securities and who are provided exemptions in the short selling process. Market makers continue to take up a naked short interest to restrict upward pricing but continue to fail to protect these market collapses by taking on the long position. The Commission must monitor such trading strategies to insure that market making protects both sides of a volatile market or eliminate the short sale exemption from market making.
4. The Commissions Office of Economic Analysis must be educated on how our markets operate at the working level as a process in evaluating the economic data. For the second time in the evaluation of short selling reforms, the methods in which the OEA conducted their analysis (specifically the duration of time) is flawed. Bear raids do not last for months but over days or weeks and such analysis by the OEA, looking over large windows of time without looking at the micro trading, is a flawed approach. Short sellers look for a quick hit on a security and at times make up an event to create such a short term profit. Analysis of this data must be taken in conjunction with short selling, settlement failures, and market declines at the micro trade levels to better understand the daily implications of short selling in our markets.

Dr. Leslie Boni, a former visiting scholar at the SEC in 2003/2004, once stated that prior to her time spent at the Commission that no in-depth analysis of short selling and settlement failures had been taken or understood. The SEC has been behind the curve in this market strategy considering only the values and not the impacts such a strategy may have on the overall markets.

Liquidity is a good thing for our markets but negative liquidity is not. Former SEC Chairman William Donaldson once stated “How much fraud are you willing to accept for liquidity”? It was a question posed to former Fed Chairman Alan Greenspan but is equally a question posed to this Commission staff.

How much fraud are you willing to tolerate for the growth in liquidity? How much in fraudulent revenue growth for the US financial institutions and hedge funds are you willing to accept, at the expense of the small less sophisticated investing public, by insuring liquidity remains strong despite the impacts?

Before you eliminate the tick test across the board you should consider how it impacts every level of market participant. How much additional fraud at the smaller market capitalized companies will there be based on this proposal? How many victims of the increased volatility will come by way of sophisticated market professions working the “fear factor” of the small investor?

The Commission needs to better educate itself on how short selling takes place before taking steps to ease the process of a short sale.

“We note that today’s markets are characterized by high levels of transparency and regulatory surveillance. These characteristics greatly reduce the risk of abusive or manipulative short selling going undetected if we were to remove price test restrictions, and permit regulators to monitor the types of activities that Rule 10a-1 and other price tests are designed to prevent.”

If only this were true.

The Commission and SRO’s never detected Anthony Elgindy and his band of manipulative short sellers; it was the DOJ that came across the activities of this now convicted felon (2006) presently serving 11 years for short selling fraud. The Commission is only now beginning to address the illegal short selling activities of 2001 as evidenced by a few “window dressing” cases taking place on a systemic problem missed.

If transparency and regulatory surveillance is so great in today’s market, why and how did the Commission miss so many fraudulent acts for so long? What has changed in transparency and surveillance? How long will it take for the Commission to address the investor losses of the more recent raids provided as well as all those others not provided but that similarly took place?

In 2000 the NASD requested Commission approval to close a loop hole used for manipulative short selling and yet the Commission sat on that proposal for 3 years allowing Elgindy to use that loop hole to commit fraud. Thus, your commentary about the integrity of market surveillance is lost to those who lay victim to the abuses you missed.

The Commission owes the public the truth in their public commentary and not the political rhetoric stated above. Making false and misleading commentary is a violation of market participants and thus should be avoided by those that enforce those rules. Protect the people not the industry member revenues.

Thank you for the opportunity to comment on this and other proposals.

Dave Patch
www.investigatethesec.com