November 1, 2008

Securities and Exchange Commission
100F Street NE
Washington, DC

RE: Release No. 34-58773; File No. S7-30-08

Chairman Cox,

There is an old Chinese proverb that goes "Fool me once shame on you, Fool me twice shame on me". As the Commission reviews the events of 2008 and considers additional and final reforms to the short sale process I urge those making these critical decisions within the Commission to investigate fully the trading activities of this past year to insure that you are not fooled again.

Fool Me Once; The Elimination of the Uptick Rule:

The elimination of the Uptick Rule was based on the heavy lobbying of the SEC by investors who engage in Quant or black box program trading techniques. The lobbying efforts suggested that the uptick rule interfered with the efficiencies in which their platforms executed trades and set forth a series of events that resulted in the elimination of the uptick rule.

I offer that the SEC was fooled by the results of the pilot program on several fronts; one so simple it was even suggested by several economists the SEC outsourced the evaluation to. Several economists suggested that the short sellers 'played nice' for the short term in order to achieve their longer term goals.

But beyond that, and more germane to present policies up for determination, is the condition of the markets during the pilot program. The SEC never tested the elimination of the uptick rule during the market sentiments that derived the origination of the uptick rule in the fist place; the Bear market.

The result; the elimination of the uptick rule has been a lightning rod for criticism from Wall Street SRO's, Institutions, traders, issuers, and investors. Congress at both the state and federal levels has likewise stepped in demanding the re-insertion of the uptick rule.

Fool Me Twice; Reg SHO and the Hard Close:

This is where I urge the Commission not to be lulled into a false sense of security in believing that the interim hard-close rule put in place in October is working to eliminate the persistent fails to deliver in the system thus reducing the abusive short selling in the public markets.

For the year 2008 the SEC continued to witness the evidence that Regulation SHO was not having any major impact on the elimination of aggregate settlement failures in our Capital Markets. In fact, as what had been on on-going trend since the origination of SHO in 2005, the number of companies listed on Regulation SHO's threshold security list continued to rise as did the aggregate mark-to-market dollar value of these failed trades.

Date	NYSE Threshold	DJIA Close	NASDAQ Threshold	NASDAQ Close	Total Threshold
1/2/2008	77	13044	253	2610	330
1/15/2008	69	12501	234	2418	303
2/1/2008	93	12743	244	2413	337
2/15/2008	74	12348	264	2322	338
3/3/2008	61	12259	245	2259	306
3/14/2008	90	11951	286	2212	376
4/1/2008	136	12654	384	2363	520
4/15/2008	103	12362	326	2286	429
5/1/2008	86	13010	301	2481	387
5/15/2008	100	12993	292	2534	392
6/2/2008	101	12504	327	2480	428
6/16/2008	99	12269	307	2475	406
7/1/2008	97	11382	290	2305	387
7/15/2008	110	10963	367	2216	477
8/1/2008	135	11326	336	2311	471
8/12/2008	108	11642	289	2431	397
8/15/2008	104	11660	284	2453	388
9/2/2008	88	11517	245	2349	333
9/15/2008	87	10918	248	2180	335
9/17/2008	93	10610	250	2099	343
10/1/2008	89	10831	237	2069	326
10/3/2008	76	10325	201	1947	277
10/6/2009	67	9955	191	1862	258
10/8/2008	59	9258	159	1740	218
10/15/2008	57	8578	138	1628	195
10/17/2008	53	8852	131	1711	184
10/22/2008	25	8519	88	1615	113
10/27/2008	11	8175	81	1505	92
10/31/2008	8	9337	59	1721	67

Table I Sample Snapshot of Regulation SHO Performance Data

Note: Dates in Red are Start/Stop Dates for Emergency Orders

As this evidence illustrates, the number of threshold securities removed from Regulation SHO is as directly correlated to the decline in our Capital Markets as it is to the insertion of Emergency Orders by the Commission. With the delay in the release of Fail-to-Deliver information, it is impossible for the public to decipher whether the fails continued to exist but were being cleaned up in a swifter fashion than had taken place prior to the October “hard-close” interim rule change.

I was interested in the specific performance of those companies that remained on the SHO list as of 10/31 based on such a significant decline to again attempt to correlate markets with settlements. Since SHO requires a period of 5 days prior to being listed and a period of 5 days prior to removal there is little absolute certainty to the data the public receives. As such, and working with the data available I did find some interesting patterns to present that would indicate that systemic abuses may remain intact.

I. Chipotle Mexican Grill (CMG). Of those 8 NYSE Issues that remain on the Regulation SHO Threshold Security List is Chipotle Mexican Grill (NYSE: CMG).

Figure 1. Chipotle Mexican Grill (NYSE: CMG)
Note: On Reg SHO for 536 Consecutive Days

CMG has been on the NYSE Reg. SHO List for 536 consecutive trade days. While the NYSE was able to clean up the failures in many of their issues, CMG remains overloaded with fails. Unlike many issuers during the recent ban on short sales and the 'hard-close" interim rule, CMG was advancing in the market. By advancing it risked the mandatory close out to a buy-in for a net loss which has long been the rationalization to maintain such a failure in the system.

The SEC must make the effort to compare the fails in CMG to those of other firms to understand the difference in how such fails are being handled at the time of closeout. If it is found that the fails have remained open due to the potential financial losses that would be incurred should the mandatory close take place immediately the SEC must act not only on those who carry these liabilities but likewise with reforms that insure that such factors do not carry over into future regulatory changes.

Questions for the SEC to Respond:

1. At the micro level, has the SEC conducted adequate studies to differentiate on why some companies are easily removed from the SHO threshold list while others are not? Specifically, has the SEC studied the pricing points of the failed trades to that of the market in which they must be covered to determine is cost factors are being considered in the close-out process?

2. How have the present hard-close provisions of Reg. SHO, under the interim final rule, addressing the persistence of failures in CMG and other securities like CMG?

3. Has the SEC carefully studied the implications of the hard-close provisions during a bull market? If those coming off Reg. SHO are selective companies based on the direction of the market trading, is it the hard-closeout provisions that impacted the settlement or was it market induced opportunities?

II. Morgan Stanley (MS). Another example of where it is believed that the SEC has ample evidence supporting alternatives to the hard-close provisions included in the interim final rule. That example comes by way of Morgan Stanley (NYSE: MS).

In the financial crisis that has impacted not only the US economy but global economies; short sellers became the vultures feeding not only on the dead but on the living. Through the use of large intra-day short selling tactics, market sentiment was being dictated by short sellers with no interest in the underlying values of the company or on efficient market pricings.

It is believed that the SEC initiated the all out ban on short sales in September 2008 due in part to the evidence the SEC witnessed with regards to rumor mongers and predatory intra-day market distortions.

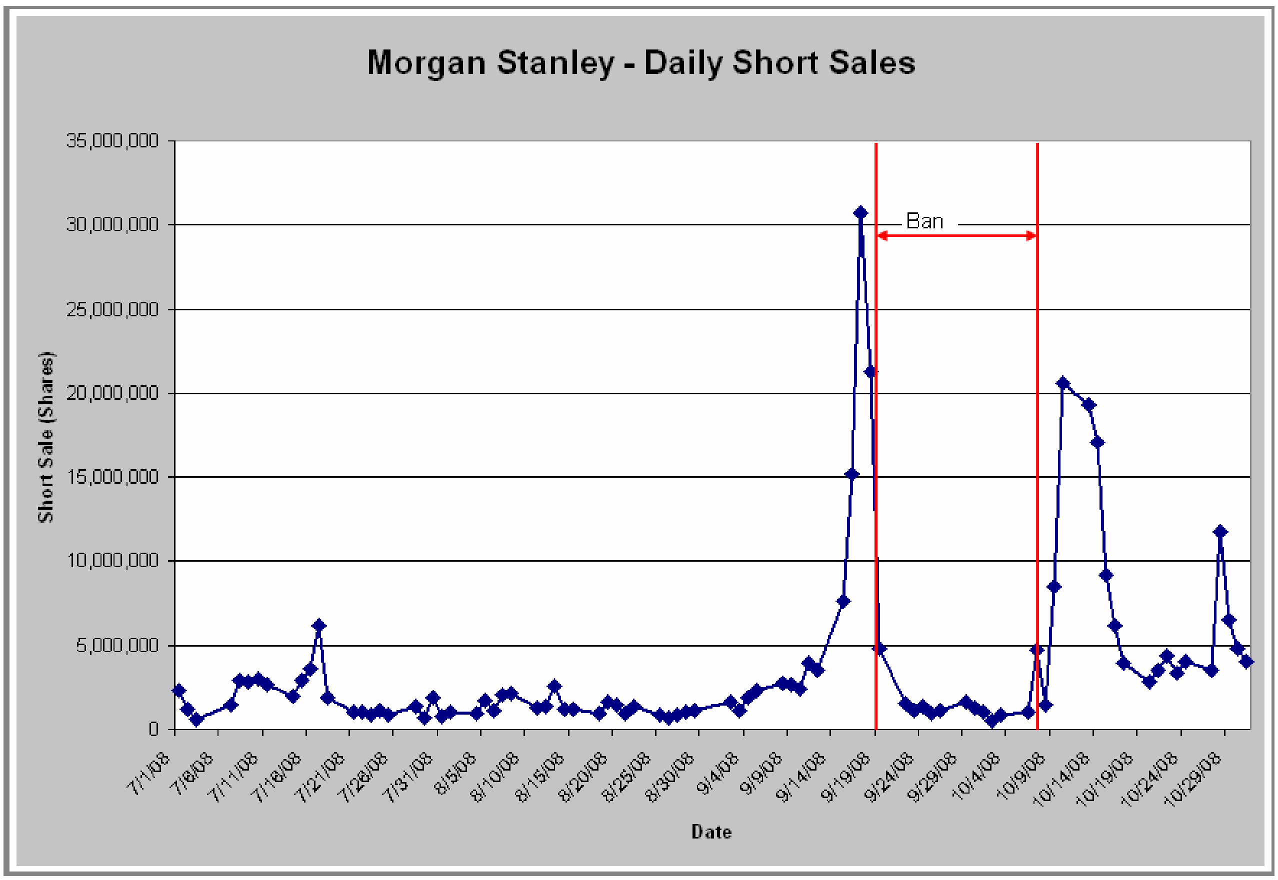

Figure 2. Morgan Stanley Daily Short Sales **(provided by NYSE)**

In the data provided by the NYSE, the exponential rise in Morgan Stanley's daily short sale interest coincided directly with the general attacks on the financial markets and specifically Morgan Stanley. Bear Stearns had already fallen as had Lehman and rumors now targeted Morgan Stanley.

In the days of September 8 2008 and September 18, 2008 Morgan Stanley's market traded from a high on September 8th of $44.24 to a low of $11.70 on September 18th. These dates correlate directly with the short sale strikes leading into the short sale ban.

Of significance in the data presented in Figure 2 is that the level of daily short sales in Morgan Stanley during the ban was near identical to that prior to the ban. As Morgan Stanley's market continued to decline in this ban, and while the Commission was being harshly criticized for the declining markets while under this ban, the Sec failed to report out to the public that the level of short sales in this declining market continued to be normal.

Questions for the SEC to Respond:

1. Clearly the evidence shows that the short sale interest in Morgan Stanley was growing exponentially in the days leading to the emergency order short sale ban. What data does the SEC have for data with regards to these trades being long term short sales vs. intra-day short sales?

2. Of those intra-day short sales, was there a significant level of trades coming from focused parties and if so, how were those trades executed relative to the locate process? Did the investor locate 100% of all short sales executed or was the same locate used multiple times by that same investor? If the investor used a common locate multiple time in that day, How will the hard-close alter trading irregularities such as these?

3. The intra-day volatility of the markets were extreme during periods in which intra-day short sales spiked. At what point does the SEC re-evaluate these trades as something other than liquidity that supports proper price discovery?

The SEC has afforded the intra-day short sellers with the opportunity to be excused from any fees associated with the sale of shares they do not control by demanding that only a locate be made to sell a security short. Only as the short persists into the trade settlement cycle (T+3) will the investor be expected to expense out the fees of the physical stock borrow.

The Commission, within this temporary rule, has elected to propose the 'hard-close' option over the 'pre-borrow' option due in part to the belief that the pre-borrow would deter the necessary short sales that would add liquidity and efficiencies in price discovery. This position taken by the Securities and Exchange Commission sounds remarkably similar to the position taken by the Managed Fund Association and lead short seller James Chanos. As drafted in the July 21, 2008 comment memo to the SEC on the initial short sale ban, Chanos and the MFA stated:

> 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.

But is this statement supported by empirical evidence or is it simply the posturing of investors who will be the direct beneficiary of loose and inefficient market regulations?

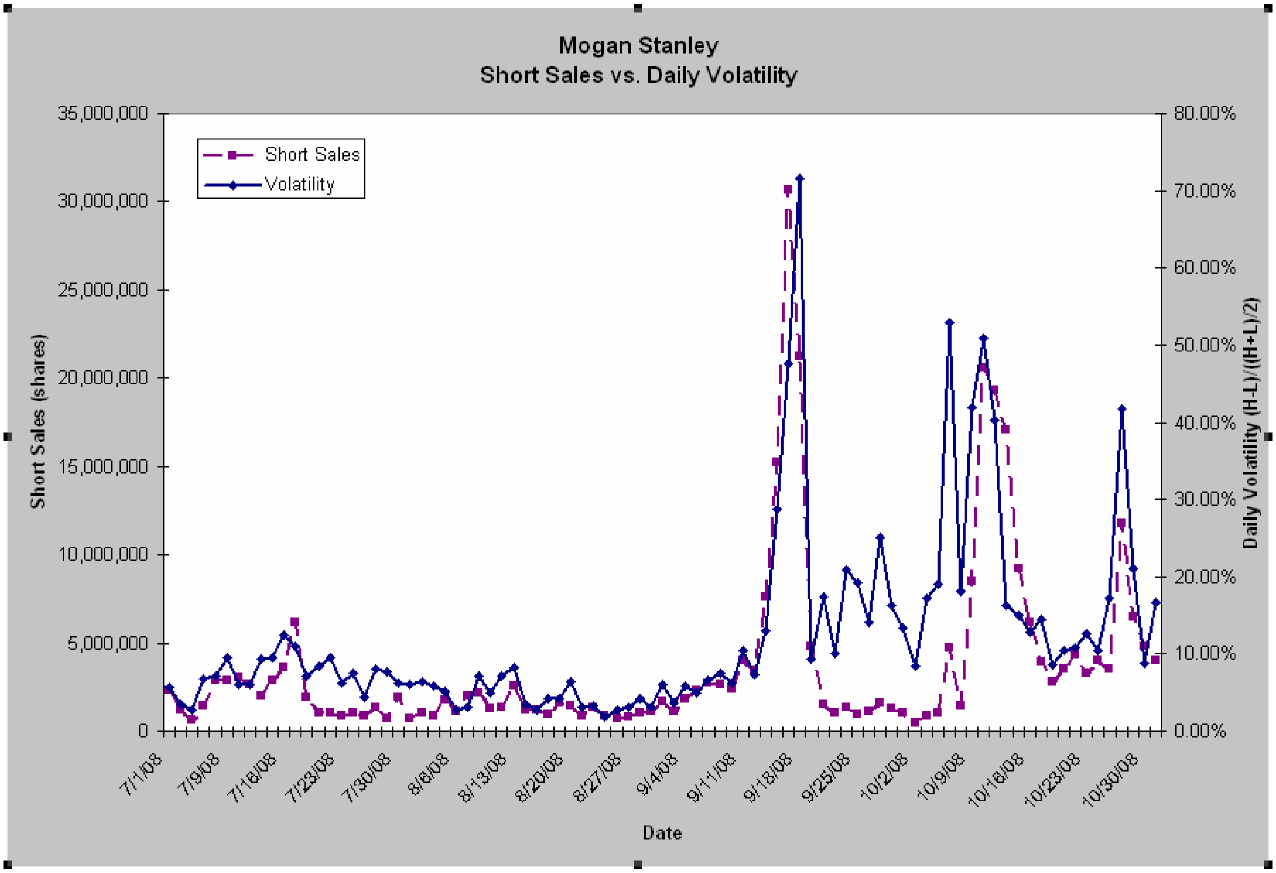

Figure 3. Morgan Stanley Daily Short Sales v. Daily Volatility

If the Commission would again focus not on the global picture but instead focus on the micro-events that transpire, I believe the Commission would be able to link market volatility to short sales directly.

In Figure 3 the evidence is quite clear as to how well correlated intra-day short sales are to the volatility of such markets. On days where the short sales explode, the intra-day swings in that market are most significant. By this chart the only period in which the two metrics are not directly linked is during that window of time when a total ban on short sales was in place (September – October).

Questions for the SEC to Respond:

1. What empirical data does the SEC have to satisfy the public that intra-day short selling provides the markets with efficiency in price discovery? Based on the MS data, it would appear that intra-day short selling can provide for just the opposite.

2. Based on the close correlation between the 'pre-borrow' experiment in July vs. the 'hard close'' experiment in September – present, it would appear that the pre-borrow requirement provides for a higher level of price discovery. What empirical data does the SEC have that would differ from this conclusion?

3. The SEC has long discussed concerns with the manipulation of markets through short squeezes or pump and dump strategies. The emphasis of such concerns is that both methods of trade distort prices and drive investors into un-necessary losses. Based on the data in Figure 3, could investors not concluded that the present 'locate only' rules pertaining to the short sale process allow for intra-day stock manipulations that likewise can drive investors into unnecessary losses? How does the Commission distinguish between the various methods of price distortion to identify what is v. what is not market manipulation?

4. Has the SEC investigated what exactly was the rationale for the short sales executed during the ban on short selling? As was much publicized, the ban was heralded as a failure due to the continued fall of the financial markets. The volatility during this period was likewise excessive as compared to prior periods in time. Who continued to execute short sales into a falling market at levels equal to periods when no ban was in place and were those trades done as bona fide market making or where they executed as strategic investments under the disguise of bona fide market making?

Conclusions:

Being that we are already in November and the Commission has yet to put up a proposal for public comment, I fear that this interim final order will prevail for much longer than the initial termination date prescribed as July 2009. if history repeats itself, a reform of this nature will take better than a year to pass through the comment and review cycle at the Commission. I am therefore taking this opportunity to present to the Commission not only empirical data to use in their rule making proposal but likewise the opportunity to address the questions that will be posed relative to any rule presented for comment.

'Fool me once shame on you, Fool me twice shame on me' and in this case, I will not allow the Commission opportunity to delay any positive reforms to impose second and third comment periods. The Commission instead is being presented up front with the questions the agency must address in the spirit of full transparency.

Ultimately, there are only two options to consider in rule-making and those are to propose either the 'pre-borrow' method which insures settlement of each trade or the 'hard-close' policy which allows for failures expecting that effective measures will be taken once a failure is reached. Most investors outside of those who directly benefit from the failed trade would say that pro-active prevention is a better policy than reactive.

In closing, I urge the Commission to carefully consider the market environment when considering the recent reduction in unsettled trades and carefully study the past several years of performance to determine whether the change in settlement policies were rule driven or price opportunity driven.

I await the Commissions next move. I would hope that the agency would consider my arguments carefully as I am clearly on record in predicting the future problems with past rule changes. The Commission must be as frustrated as I that this issue is not behind us so that both you and I can move to other efforts.

David Patch
www.investigatethesec.com