January 14, 2009

Ms. Florence E. Harmon
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-9303

Re: Release No. 34-58773: File No.S7-30-08;
Amendments to Regulation SHO – Rule 204T

Ms. Harmon:

It is with pleasure that I am able top respond to the SEC's request for comments on even more proposed changes to the short sale rules. What is significant in this opportunity is that this is not the first, not the second, and not the third opportunity to present opinion on short sale reforms. It seems instead that the public is requested to comment on such proposals on a regular basis as the rules created in response to public comment continue to be insufficient in achieving the desired intent of eliminating fraud and abuse.

In past rule proposals I would be the first to respond instead of waiting out industry members responses. This time I tried a different tact and am glad I did. As anticipated, member firms and hedge funds waited until the deadline of December 16, 2008 to respond insuring that they were the last comments the Commission received. Interestingly, each comment submitted sounded quite similar and thus each missed the basic foundation to the issue needing address – the settlement failure.

Conclusion:

I believe that the Commission must focus their attention to this particular change and to commit that what is finally adopted here is change that finally meets the intent of this exercise. The investing public and public issuers can no longer be put in harms way by rules and policies that allow for some level of abuse to exist solely for the reason of generating revenues to market members and participants who chose to take advantage of lapses and loopholes in regulatory policies.

The comment memo's presented by the member firms, lobbyists representing the members, lobbyists representing hedge funds, and the short sale hedge funds are all based on a foundation that settlement failures are a necessity in their trading operations. This basic conceptual flaw has become the foundation on the loopholes that have become a black cloud over these capital markets as out of these loopholes derived abuses. Such a foundation is likewise in direct contradiction to the implied language in Rule 15c3-3

It is my recommendation that the Commission consider carefully the principles defined by Section 17A of the Securities Act of 1934 and draft rules that support the principle of prompt and accurate settlement of trades. To do so must include policy that does not anticipate a settlement failure to happen but instead provides for a high degree of confidence that a trade will in fact settle within T+3. I believe, as it pertains to the short sale policies that such a policy can only meet the defined goals with the admission of a rule that requires a mandatory pre-borrow of all trades executed on behalf of a short sale.

Since the Commission recognizes that there are other causes for a failure to deliver to take place, including a fail by an investor long the stock but whose holdings have been out for loan, these issues likewise require rule modifications to address such issues. At the present time, long investors sell out their positions into a settlement failure due to the failure of a recall on the loaned shares. Such failure on a recall of shares must be accounted for within the regulatory structure of this change. I would suggest that upon failure of delivery of recalled shares by the recall +2 dates, a mandatory buy-in notice should be issued against the failing firm to reduce the duration of the settlement failure.

The only viable solution that will end this long standing debate is to modify the rules such that any short seller who wishes to sell a share must have in their possession that share to sell. There shall be no more allowances for short sellers to sell and cover within the settlement window in order to avoid the fees associated with a short sale. A stock borrow is part of the trade and a stock settlement is a mandatory expectation of a trade conclusion. Taking on a rule that allows for trade failures to exist due to errors is not acceptable at a time when trade volumes and liquidity are at record levels.

The Commission has attempted to temper the rule changes for the better part of 4 years and the slow and tempered approach has simply allowed those who want to game the system to do so with the loopholes provided by the Commission. Without a mandatory pre-borrow the next loophole to abuse is that of the day trade market raids which are now cropping up in these markets.

The day traders sell massive volumes short creating the impression of a sell off and cover into a real sell off they created. The seller, under present rules, can locate the same share multiple times and the SEC audits and SRO audits would fail to detect such. If the seller fails to settle on time due to financial inefficiencies the rules continue to allow flexibility on exactly when that trade must be fully settled. Cost is always the underlying factor.

The SEC missed Madoff and other schemes because they failed to stay ahead of the criminals. For a change in pace, why not stay ahead of them instead of chasing what you can not catch?

Discussion:

The Commission has struggled to adequately protect the investing public from abuse based almost entirely off the presumption that trade settlement failures can and should exist. Such acceptance is grossly outside the design and the intent of the language drafted into the Securities Acts of 1933 and 1934 representing the Congressional mission of the securities and exchange Commission.

On December 19, 2008 the Options Exchanges grouped together and drafted a single comment letter to the Commission. In that memo the exchanges state:

> *The Options Exchanges feel strongly that, while the September 17 emergency order and the current interim final temporary rule may have significantly decreased fails, they have also caused market volatility, raised borrowing costs and contributed to the widening of options bid/ask spreads. What is more, we understand that clearing firms are <u>taking every precaution to avoid even the possibility of failing to deliver</u>.* [1]

Taking precautions to avoid a fail to deliver, isn't that exactly what the SEC expects of clearing firms? Didn't the Commission promulgate rule 15c3-3 requiring that no trade would be executed without full intent of meeting trade settlement? If new rules being considered somehow force these

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[1] Option Exchange Comment Memo Dated December 19, 2008 http://www.sec.gov/comments/s7-30-08/s73008-56.pdf

firms to reduce market risks by imposing policies that meet the basic principles of regulatory law isn't that a good thing?

I ask then, why do our Capital markets even need to accept the trade settlement failure as standard operating business? Why can't policies be put in place that restricts the possibility that a settlement failure will take place instead of arguing on when such a failure should be closed out and how?

The lobbyist representing the member firms likewise agree with the options exchanges regarding the process of trade settlement:

> *Moreover, since data previously released by the Commission demonstrates that the vast majority of fails settle naturally within a few days following the regular settlement date, SIFMA's proposed amendment <u>would allow for market resolution of normal course settlement delays without requiring otherwise unnecessary transactions</u> that might result in temporary artificial price swells, impeded liquidity, or needless market risk and expense.*[2]

Wouldn't a more viable solution addressing the SIFMA concerns be to eliminate the risk of settlement failure all together as opposed to rationalizing why softer terms should be put in place when addressing how to handle a settlement failure? Hasn't history proven that when left to the honor system of the member firms market resolutions through normal course settlement was not happening with any level of consistency?

The SEC must carefully consider that if 'temporary artificial price swells' can take place and market volatility is increased due to the necessary requirement of a buy-in, what if any impact was the originating trades that created the settlement failure? Has SIFMA or the SEC analyzed the direct market impact at the time the trades were executed into these markets? If not, how does the SEC or SIFMA determine what is proper price discovery and what is not when the price reflected was created off the sale of shares that could not settle and with the lack of an uptick rule, sales that could be saturating the market bids in a security.

> *As a general matter, the vast majority of fails to deliver do not involve the type of abusive "naked short selling" activity that the Commission has sought to address through Rule 204T, but rather can stem from the complexity of the settlement process that impacts the flow of securities to the broker-dealer that has a CNS delivery obligation.*[3]

Fails to deliver can be eliminated by borrowing securities and delivering the borrowed securities.

> *However, Rule 204T(a)(l) forces a broker dealer to "buy-in" a long sale attributed to the fail to deliver, even if securities are available to borrowing to make delivery. The buy-in requirement is not appropriate or desirable because 1) the buy-in causes unnatural demand and additional unnecessary trading volume to occur, 2) the buy-in must occur by the opening on S+3, thus potentially skewing normal trading volumes and market prices, 3) the buy-in may have a worse economic impact on the party bought in (who in most cases will be a long or short seller, or trading counterparty) and so potentially reduces the desire for such a person to trade in the equity markets and 4) it may be cheaper to borrow rather than to buy-in, and 53 borrowing*

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[2] SIFMA Memo Dated December 16, 2008 http://www.sec.gov/comments/s7-30-08/s73008-52.pdf

[3] SIFMA Comment memo

resolves the open fail to deliver more quickly than the buy-in because the buy-in has a longer settlement cycle.[4]

In September 2008 the Commission imposed a moratorium on short sales in nearly 1000 securities. The intent of this moratorium was to slow down the rapid decline in confidence in these markets. Some perceived the move to have greater intent, to drive the markets up, but the result was not upward momentum, it was continued decline in the markets.

SEC Chairman Chris Cox would later contend that the move by the Commission to ban short selling was an error.

"…the biggest mistake of his tenure was agreeing in September to an extraordinary three-week ban on short selling of financial company stocks. But in publicly acknowledging for the first time that this ban was not productive, Cox said that he had been under intense pressure from Treasury Secretary Henry M. Paulson Jr. and Fed Chairman Ben S. Bernanke to take this action and did so reluctantly.[5]

But was it a mistake and if so how? Is it because despite the ban the public continued to witness a decline in the markets protected by the ban? If so, and if the Chairman wishes to make such bold public statements the Sec is likewise expected to present the total picture and not just that which supports the opinions of the Commission at the time.
The fact is, short selling in these markets was not eliminated at all. Due to several exemptions the Commission later created, the short selling taking place in these markets, as compared year over year to the short sales in these same markets in 2007 was substantially greater despite the ban.

Using reported data from the NYSE, Deepcapture.com evaluated the level of short selling taking place in the originating 797 companies identified by the SEC as being protected under the short sale ban. Since this is only the reporting's of the NYSE ARCA the total short sales in both reporting periods could be greater than presented but it is unlikely that the overall presentation would change.

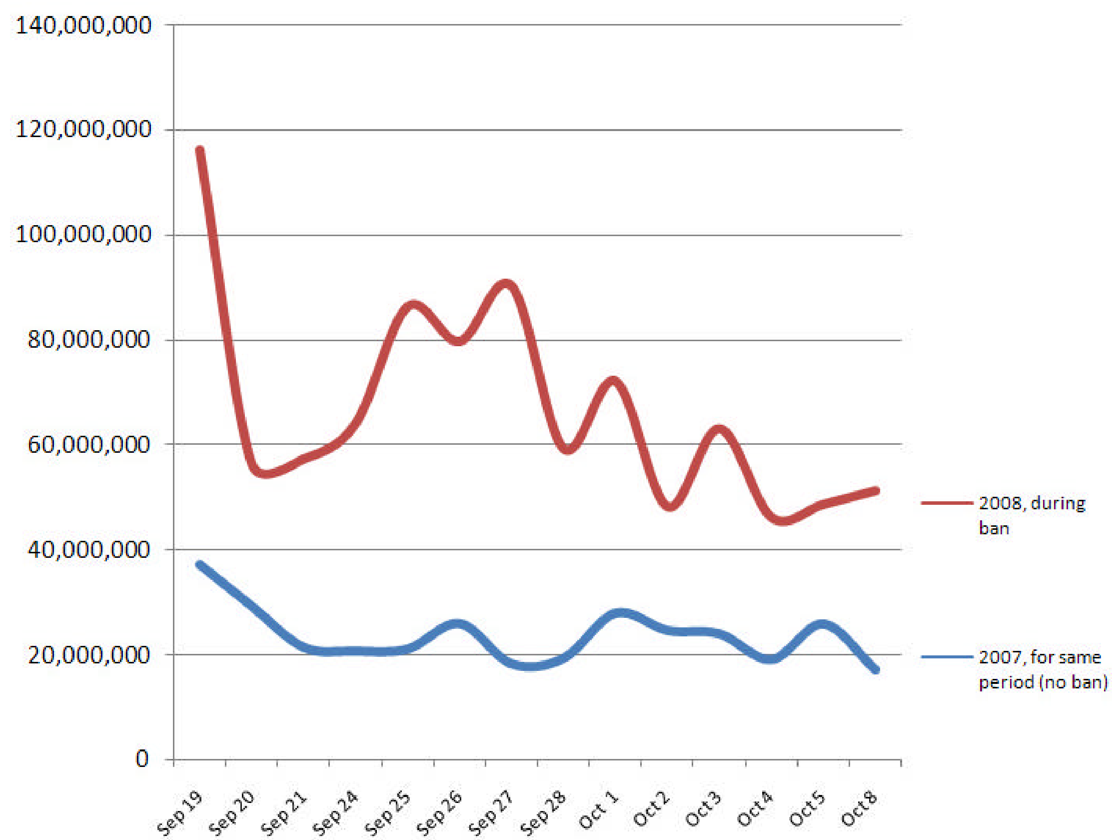
This chart below illustrates the year over year short sale activities in the 797 companies involved in the originating ban.[6]

[4] Wedbush Morgan Comment Memo

[5] Amit R. Paley and David S. Hilzenrath, "SEC Chief Defends His Restraint," *The Washington Post*, December 24, 2008.

[6] Judd Bagley "940 Million Holes in the Wall; Whither Short Sale Ban" http://www.deepcapture.com/940-million-holes-in-the-wall-whither-short-sale-ban/

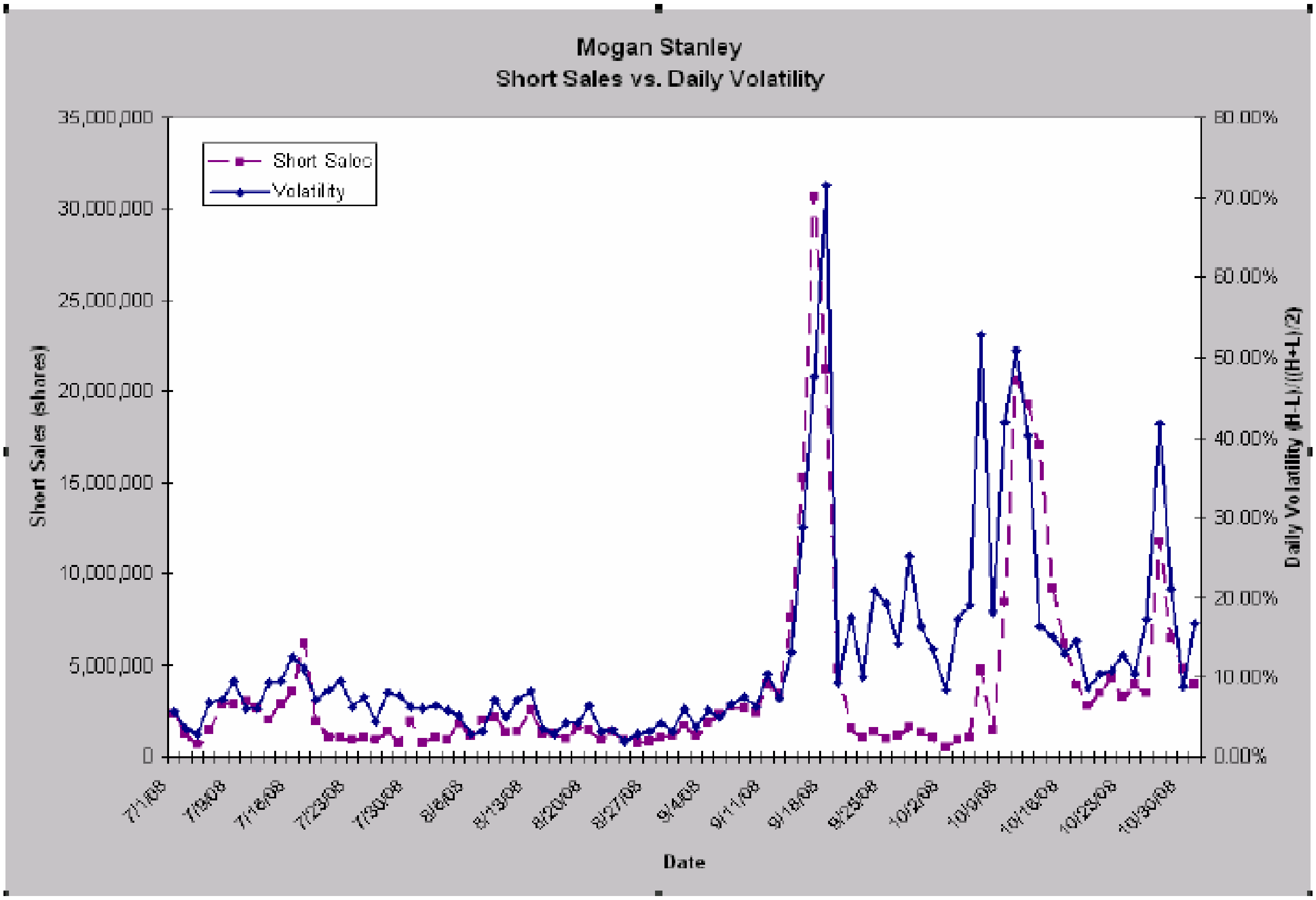
Short sales in banned, financial stocks on NYSE ARCA



The Commission was obligated to present this data to the public as this data clearly illustrates that a ban, as it would be understood by the general population was not at all what was happening. Short sale activities continued in the markets and there is no way to differentiate how these trades were being executed into the market at the time of the sale and how or if these trades aided in the continued market decline.

I would ask, what research and analysis has the SEC conducted with regards to these trades, the legal execution of these trades, and whether the exemptions used were based out of necessity or whether members used them for advantage in proprietary trade strategies?

Let’s, for example, take a look at the short sale activities in Morgan Stanley that lead to the short sale ban in the first place.



This chart identifies a significant spike in short sales for Morgan Stanley in the 5 days that led to the ban on short sales. Clearly without the ban in place there is no way for the Commission to gauge whether the peak we see on September 17, 2008 would have remained the peak in short sales for this market. What we do see, however is that the short sale activities in Morgan Stanley returned to the levels previously seen just prior to the spike event and yet the markets day to day volatility remained much higher.

Volatility in this case is a simple look at the day's high and low trading range as compared to the average of the two. Outside of the period under the ban, the two metrics closely tracked each other. Such divergence could be based on the ban itself or, since the markets continued to see a selloff during the ban, that other unnatural influences such as hedge fund redemptions and a general movement to cash created the volatility and that ban or no ban the results would have been similar.

I believe that any analysis of the short sales taking place in the trade days leading to the ban would identify that much of this trading was not long term short sale positions but short sale positions opened and closed within the settlement window. These trades could continue to exist today under present regulatory proposals and interim final temporary rules. Until the Commission somehow responds to the public concerns over this trade technique and insures that bear raids such as these could not happen continue to take place, the Commission should not consider reforms that contain such loopholes in the short sale process?

The public has responded with thousands of comments over these years relative to what they witness and what there concerns are in the short sale policies. To date the Commission has discarded nearly all these concerns listening only to the wants and needs of industry members who, as history has shown, have put their own self-interests above those of the general investing public. Can our Capital markets continue to suffer through a lack of investor confidence as those the Commission puts the highest regard for are the very same who are exposed as frauds and cheats?

It is the Wall Street members and their biggest clients who are routinely exposed for being involved in major scandals. These scandals are exposed late in the game and well after the public has become the victim. Never do we hear of Wall Street coming forward and exposing the fraud, rarely we hear of people like Harry Markopolos stepping forward and exposing a scandal but people such as Mr. Markopolos are few and far between in this industry. Most fear exposing fraud because of what it would mean to their personal bottom lines.

Short sale abuses have long been in these markets as evidenced by an increasing level of settlement failures. Recognize that it was not the industry that stepped forward and addressed concern, despite the increasing level of liabilities on their books, it was the investing public because it was the investing public that was most injured.

When you look to a hedge fund and what they provide, Hedge Funds expose what they believe to be wrongdoing at the business levels but never do we hear of a hedge fund exposing market fraud, manipulation, or trade abuses. I ask, how many hedge funds came forward to expose late trading/market timing? How many hedge funds came and exposed the gang rape of companies in an “enterprise” of funds? How many hedge funds file a complaint to the Commission when they are made aware of non-public information coming across their trade desks? I believe the answer is rarely if ever.

The members today and the short selling hedge funds today want the Commission to leave them alone and to trade in full secrecy. They do not want to report their actions and they want you to excuse the “temporary failures” they have so frequently. This should be a red flag and thus the Commission should act upon it instead of ignoring it.

A short sale is about borrowing a share and selling it short. It can no longer be about promising to borrow a share later as promises are never kept on Wall Street. Something the Commission should have learned after a decade of embarrassments.

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