July 22, 2006

Nancy Morris
Secretary
Securities and Exchange Commission
Washington, DC

RE: Amendments to Regulation SHO [Release No. 34-54154 File No. S7-12-06]

Ms. Morris, Commissioners of the SEC,

Let me first thank you for allowing this opportunity to comment on such an important rule change such as this one. I believe that over time you will understand the significance of the changes you are about to embark on as they reflect on the overall effectiveness of the Capital Markets and investor confidence in these markets moving forward.

Let me start first by stating clearly what assumptions I am making in preparing this comment memo and in the analysis I will provide throughout.

1. The Capital Markets are to be structured in a manner in which all participants in the trading activities are treated equally and fairly.
2. The laws that bound these markets are intended to insure that all participants have an equal right to generate profits and take on an equal risk to possible losses.
3. The investing public, and the interests of the investing public, are put above all other business enterprises.

While I do not want to dwell much on the past, I believe that references to the past are essential in order to pave the way to a more efficient future. In this case, the past I will be referring most to will be our recent past and the original inception of Regulation SHO.

Background

In June 2004 the Commission approved a version of Regulation SHO that contained an added feature not presented to the public for open comment. That feature was the “grandfather clause” and as has been stated several times by the commission, this clause was created to protect the capital markets from the potential of short squeezes. This clause is now up for reconsideration, as it became a loophole that was used to continue market abuses.

During the most recent SEC public hearing the SEC identified that the grandfather clause was incorporated into Regulation SHO in order to mitigate any potential for short squeeze volatility in forcing the closure of past settlement failures. The staff of the Division of Market Regulation stipulated that the past 18 months have been a success in that 34% of the average daily fails to deliver (FTD’s) have been reduced since January 2005 and that in the process the market affect of a short squeeze was mitigated.

- While short squeezes were being mitigated by the grandfather clause, were bear raids equally being mitigated?

I believe that it is the responsibility of the Commission, as the team evaluates changes to Regulation SHO, to not simply look at the settlement failure numbers aggregately from the 10,000 foot level as the measuring stick for guidance but to look closely at the details behind how these stocks have seen the levels of fails reduced. In doing so, decisions on such features as the elimination of exemptions to market makers and options traders will be more understandable.

I will also content that the SEC must create market practices that operate off the principles of equal opportunity to all investors, which included market participants, and that the SEC must consider exactly what authority they have in the price control of any given trading issue.

Data Analysis of Past 18 Months:

Under the Freedom of Information Act (FOIA) an associate was provided raw information relative to the aggregate number of fails for the NASDAQ and NYSE between April 2004 and April 2005. In this data the results show that between June 2004 when the Commission passed SHO and January 2005 when SHO was introduced, the average daily fails in the system had increased by 35%. The average daily number of fails for the month of June 2004 was 159 Million shares and had increased to an average daily number of fails in December of 205 Million shares.

Due to the mechanics of the grandfather clause, and the 6-month window of opportunity for the Industry to generate fails, I believe the Industry took total advantage of this opportunity and used the 6-months to generate additional leverage on their positions through abusive trading practices.

- Did the SEC review and understand the cause for such a tremendous rise over this critical period in time?
- Was this typical of previous years performances or an anomaly?
- How was the overall market during this period in time and how did those issuers who absorbed the lions share of these fails fare as compared to the overall market?

Because of this large spike leading into SHO, I believe the SEC's analysis of the success of SHO should not be based on the figures identified for January 2005 but should be based on when the SEC first approved Regulation SHO and how the Industry responded overall to that news.

- Did the SEC properly evaluate the cause for this significant increase leading into January 2005 and have these issued been properly addressed in the proposal now before us?

The significance of such analysis is that a failure to settle in the markets is a financial liability carried solely by the institution responsible for the delivery of shares.

To the client representing a long or short trade, the share remains a book entry in their account representing the belief and understanding that the trade was properly executed. Any failures in that execution (under the guidelines of 15c3-3 and 15c6-1) are the liabilities solely encumbered

by the member firms. Analysis of how the members later relieve their books of this liability is what requires further exploration.

I believe in this most recent proposal, the SEC expressed concern over the business matters relative to these members yet; the SEC has a higher responsibility to the protection of existing shareholders than they do to future shareholders and Wall Street business operations. Today's investors need to be protected before allowing more investors to enter into a market of possible abuses.

Ultimately, Investors are not brought to Wall Street at the satisfaction of the member operations; the member operations are brought to Wall Street at the satisfaction of the investors. The members represent businesses like all others and therefore must weight risk vs. reward in their daily activities. The SEC rulemaking is not expected to insure the member's risks are reduced or eliminated as that simply places the higher burden of risk on the investing public.

Trading Under Regulation SHO:

Again, to understand the markets and Regulation SHO the data over the past 18 months must be put into perspective. To do so, I considered taking several different tactics to evaluate the effectiveness of Regulation SHO with respect to the interests of the investing public. My analysis does not take into consideration any of the financial liabilities or interests of the corporations that make up Wall Street, as they are irrelevant to this issue. These are businesses responsible for their own risk taking measures.

I. NASDAQ Securities under SHO.

On January 7, 2005 the NASDAQ threshold security list contained 107 companies identified for the NASDAQ NMS or NASDAQ small cap markets. On March 7, 2005 that number had been decreased to 92 companies of which 40 were part of the original January 7 publication.

In looking simply at the closing prices of these 40 securities on these two trade days, 29 of the 40 issuers had a representative decline in stock values with an average decline of 24.35%. Of the remaining 11 companies on the list, there was an average increase in stock valuation of 54% with 2 outliers representing 190% and 181% market increases.

Ironically, several of the companies listed with large price declines, continued to see significant increases in the reported short positions.

- How did these additional shorts, when shares were unavailable to settle existing trades, impact the stock prices?

Conducting a similar inspection of the NASDAQ listed threshold securities, this time looking between January 7 and May 3, 2005, revealed a similar type perspective of how companies were fairing while on the threshold security list.

On May 3, 2005 the number of NASDAQ listed securities on the threshold list had been reduced to 82 from the original 107 companies identified.

Again comparing closing prices for these two dates revealed that 22 Companies were listed for both days. Of the 22, 16 continued to show declines in market values with the average decline across the 16 companies representing a 33% market cap loss. Of the 4 that had continued to

demonstrate positive trends, the average market value improvement was 82% with two remaining outliers at 150% and 167% market improvements.

The final day I evaluated was August 26, 2005, some 8+ months after Reg SHO was in place. On this day there were only16 companies listed that were also listed on January 7, 2005.

Of those 16 companies, 11 remained trading significantly below the January 7 market price while 5 traded above the market. The market loss in those 11 securities averaged 43%. A trending concern seen over the three test dates evaluated (24% to 33% to 43%).

- Were the long investors in these securities being properly protected under fair market practices or did the grandfather clause put the financial protection of the members, and their ability to control markets, above that of existing shareholders?

According to the CNS trade settlement data provided under FOIA, the average daily level of fails on the NASDAQ/NYSE had been reduced by 24% comparing the fails to June 2004 and 42% if compared to the fails leading into January 2005 by May 2005. In the recent proposal submitted by the SEC, the aggregate fails over the past 18 months were reduced by only 34%.

- All things being equal, would this data not imply that Regulation SHO was effective for possibly 4 – 5 months and then became ineffective in further reducing fails in the system?

Average Fails to Deliver by Month
(Data provided under FOIA Request)

	Avg OTCBB/Pink Shhet/AMEX	**% Deviation from Dec 2004**	**Avg. NYSE/Nasdaq**	**% Deviation from Dec 2004**
Dec-04	**576,101,354**	**0.00**	**205,174,477**	**0.00**
Jan-05	528,921,864	-8.19	143,756,942	-29.93
Feb-05	450,813,162	-21.75	125,702,815	-38.73
Mar-05	379,989,408	-34.04	128,362,273	-37.44
Apr-05	**406,291,020**	**-29.48**	**118,048,055**	**-42.46**
Jun-05	351,592,924	-38.97		
Jul-05	389,023,458	-32.47		
Aug-05	379,351,504	-34.15		

The SEC also documented in this proposal that 99.2% of the original grandfathered fails had been eliminated by May 2006. While this number appears high, the means in which these fails were eliminated are in question. I also believe that the SEC and NASD have questioned the means in which these fails, and specifically the grandfathered fails, were being removed from the markets.

In May 2006 the NASD submitted an interpretive letter (http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_016418.pdf) identifying how the order of fails were to be removed from the system. Most recent fails to be removed first and

grandfathered fails, which occurred at the higher market prices, only through attrition. This interpretive memo was the result of the audits that identified that the clearing firms were improperly applying closeouts to fails.

When a fail occurs on a threshold security where that security is continuing to decline as was the case in many SHO issues evaluated, the longer fails are fails that are most in the money and the most recent fails are closest to present market values. By closing out the most aged fail first, the clearing firms were taking profit from the grandfathered fail while switching it for a less profitable or out of money fail in the system. Further fails could then be created to further depress the stock while making these most recent fails more profitable at the time of a later “illegal” cover.

- What percentage of the grandfathered fails were improperly closed out and to what extent were profits increased to the originator of these aged and new fails by applying the rules improperly (illegally)?

My conclusion in this analysis is that for the NASDAQ market, the trade data illustrates that while short squeezes were not commonplace under SHO bear raiding may have been and the beneficiary of these raids were in fact the member firms who have the inside track in controlling the markets. The guidelines of SHO were further ignored insuring by the members to insure higher profitability than would otherwise have occurred.

II. Stocks Coming off SHO

Again, using data provided under the FOIA, several of the more prominent SHO threshold securities were evaluated for performance as they were coming off SHO.

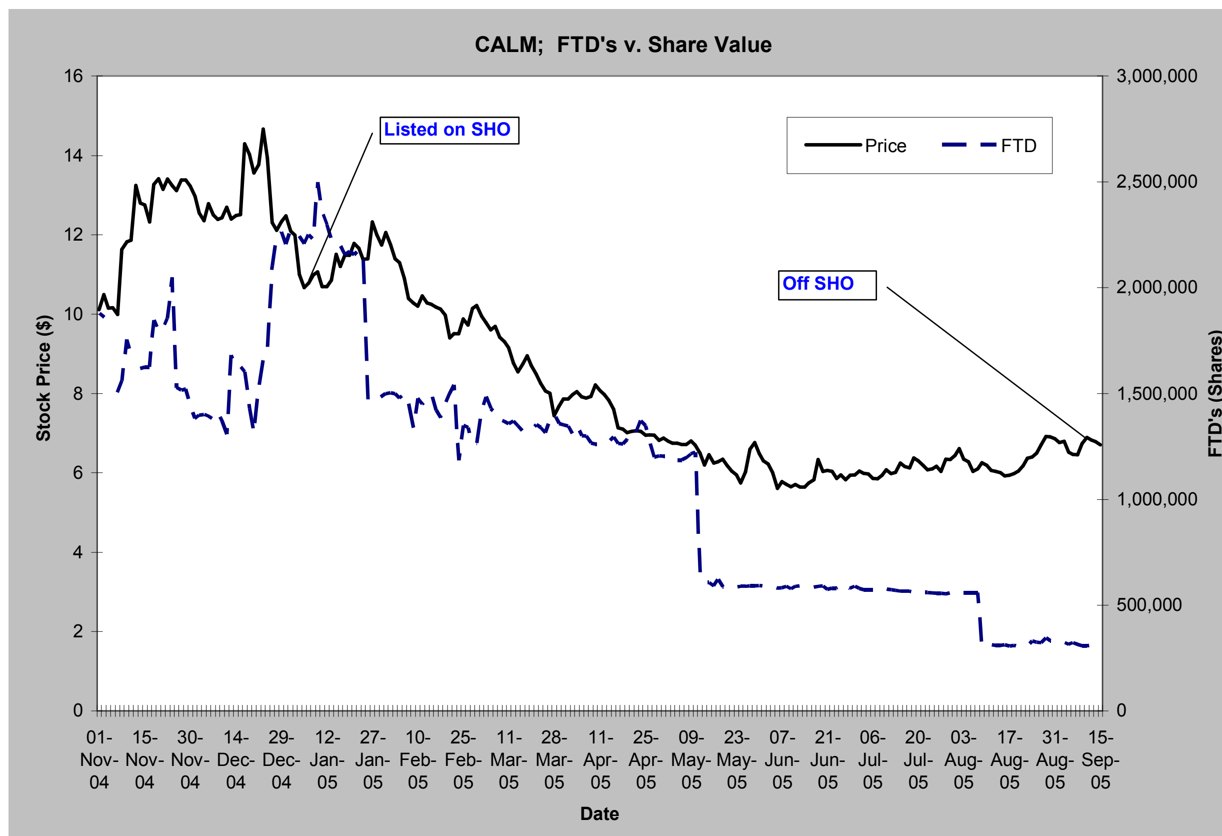
Cal-Maine. Data tracking of the fails (institutional liabilities) for Cal-Main provided insight into a common trend seen elsewhere on other SHO companies. For Cal-Maine, the trend over a 9-month period was one in which the stock price, average trade volume, reported short position, and reported fails all trended down proportionally.

By the end of the 9-months, as Cal-Maine came off the Regulation SHO list, the stock was 50% below its January values, the fails were reduced by 77%, the short position was down 74%, and the average daily trade volume was down 75%.

The question I raise regarding the trading in Cal-Maine is simple.

- Was the use of market making exemptions and option trader exemptions used to “work” the market in Cal-Maine to eliminate the institution liabilities for profit?

Of significance, once Cal-Maine came off regulation SHO the stock immediately responded positively and has recovered back to a May 2005 levels. I believe this recovery was in fact associated with the lack of sell-side pressures put into the market by the firms carrying the settlement failure liabilities to induce shareholder selling into covered fails. The business profile has not changed for Cal-Maine the market conditions of the stock did.



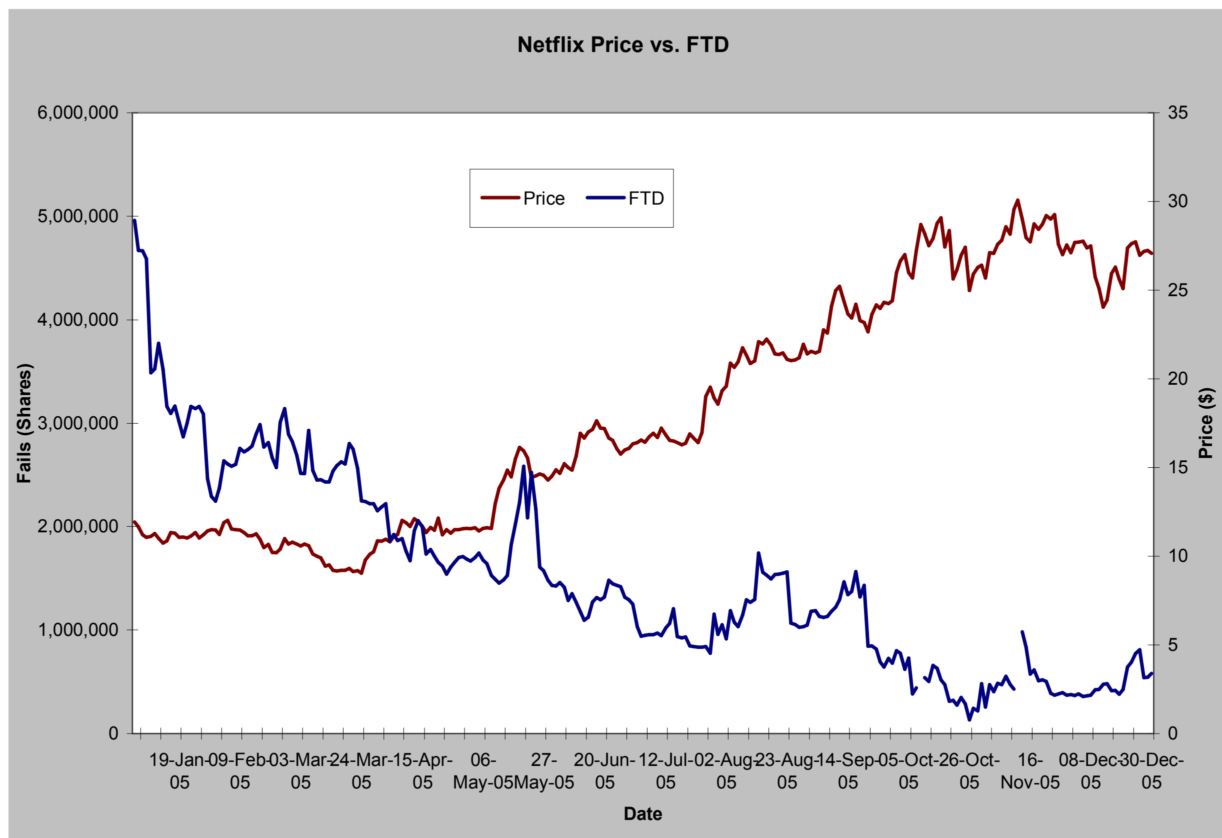
The raw data that comprises this analysis can be located at http://www.investigatethesec.com/Calm_Maine_FOIA.xls.

Netflix. Similar to Cal-Maine, Netflix entered 2005 with an extremely large percentage of the shares outstanding in a settlement failure. The 2004 trading season saw a significant market decline between June 2004 when SHO was approved and January 2005 when it was incorporated. In fact the stock lost over 60% of the market value in these months as the fails continued to accumulate.

Within the first 4 months of trading in 2005 the stock remained flat as the fails in the system were being reduced from 5 Million FTD to 2 million FTD. This was also the period in which the trade volume was at its highest daily average and when the largest change in market FTD's were being recorded.

What makes the data on Netflix intriguing are days like January 4, 2005 in which the number of shares traded that day (2.48 Million) resulted in a reported reduction in CNS fails 3-days later of 1.1 million shares? The presumed closeout purchases represented 44% of the total trade volume for that day and yet the market for that day closed down 2.4%. This reported trade volume represented more than 5% of the total public float in the stock.

Eventually, as the fails were reduced to manageable levels the markets could no longer control the trading in Netflix and the stock began to rise. There were continued spikes in the FTD's as the stock demonstrated exuberance as seen in May 05 and later in Aug 05.



The raw data that comprises this analysis can be located at http://www.investigatethesec.com/20060712.xls.

There are several more issuers who trading patterns mimicked these Patterns where, from outward appearances, it is easily concluded that the institutions carrying the liabilities of these grandfathered fails were using their market exemptions to cover the fails at guaranteed profits.

Responses to the SEC's Request for Answers:

Q: Should the 35-day proposal be extended to 60 days or longer?

A: No. As proven previously, the SEC provided the Industry an opportunity to begin the process of compliance and instead abused that opportunity. By December of 2004 the average level of fails had increased 35% for the NYSE/NASDAQ over that which was in place when SHO was approved in June 2004. In addition, this proposal and this comment period are ample opportunity for the Institutions to start on their own this process making compliance and spirit of the laws part of their daily obligations.

Average Fails to Deliver by Month (Data provided under FOIA Request)

	Avg. OTCBB/Pink Sheet/AMEX	**% Deviation from June 2004**	**Avg. NYSE/Nasdaq**	**% Deviation from June 2004**
Apr-04	665,529,486	45.5887809		
May-04	470,034,129	2.82293611	161,194,255	3.34864559
Jun-04	**457,129,651**	**0**	**155,971,328**	**0**
Jul-04	490,078,028	7.20766569	159,801,933	2.45596742
Aug-04	990,135,473	116.598392	162,034,448	3.88732986
Sep-04	935,907,792	104.735744	152,671,580	-2.1156119
Oct-04	688,416,033	50.5953577	165,042,191	5.81572467
Nov-04	506,538,603	10.8085205	171,732,922	10.1054432
Dec-04	**576,101,354**	**26.0258119**	**205,174,477**	**31.5462782**
Jan-05	528,921,864	15.7050003	143,756,942	-7.8311739
Feb-05	450,813,162	-1.3817719	125,702,815	-19.40646
Mar-05	379,989,408	-16.874916	128,362,273	-17.701366
Apr-05	406,291,020	-11.121272	118,048,055	-24.314259
Jun-05	351,592,924	-23.086826		
Jul-05	389,023,458	-14.89866		
Aug-05	379,351,504	-17.014461		

Settlement failures have become abusive to the investor and presently the Institutions are taking advantage of such abuses. For clarification, the 35 days must be calendar and not trading days.

Q: Will Proposed Amendments create additional costs associated with surveillance, etc…?

A: No. The DTCC has reports that identify the date, duration, and participant in every failed trade. In addition, this proposal, in forcing all trades to settle thereafter, will eliminate the cost and efforts presently necessary for maintaining records of pre and post SHO fails.

The grandfathering clause actually made the efforts of surveillance and compliance more cumbersome by forcing these firms to properly identify exactly when an issuer is listed on SHO and thus, which fails were grandfathered and which were not. In fact, this effort failed as the firms instead simply closed out the oldest fails first and have ignored their legal obligation to close out those non-grandfathered fails post SHO as highlighted in the SEC's Q&A update and NASD guidance on such matters.

Q: Duration of Notice timeline for implementation?

A: The Industry is already on notice and therefore no additional notice is necessary. All grandfathered fails should be closed out within 35 days of the new rule being published in the Federal Register with exemptions being addressed on a case by case basis only. A notice period defeats the point of a 35-day window to close out fails. Rule 15c3-3 and 15c6-1 provide rights to the purchaser, as does UCC Section 8.

Where is the SEC's concern over these rights? It is these rights that the SEC should be considering and not the rights of potential abusers which include market participants.

Q: Grandfather Clause – What harm does it impose on market quality and investors.

A: The easiest answer is that the grandfather clause is unconstitutional and therefore not even to be a consideration for future existence. Under the Fifth Amendment the people are afforded the right to property and such rights cannot be taken by anybody, including the govt. without proper cause. Allowing the transfer of property to remain on the sell side of the market, after the buy side has purchased and paid in full for such property, is not a decision the SEC or the seller is provided. The Fifth Amendment requires that if such property is to be taken, proper compensation must be made and yet not only is the buyer unaware of such theft but compensation is not provided.

The clause allows the broker dealers to effectively take the property of the intended investor without the approval of that investor. There is no notice to the investor that the commissions paid for services rendered did not in fact result in those services being met. Instead the representative broker colluded with a selling party to delay delivery in order to increase their revenues as well as the selling broker dealer revenues by adding the liquidity of unregistered shares enters the marketplace. The SEC should be looking into the accounting practices of these firms as the booking of the commissions prior to the delivery of shares would be a violation of accounting standards (ala... Retailers booking sales prior to the shipment of such product for which the SEC initiates enforcement actions on)

In addition, Section 17A of the Exchange Act clearly outlines that all trades must settle promptly, including the transfer of ownership, in order to protect the investor and the industry from damages. Has the Commission now come to some differing conclusions than those messages of guidance by Congress? If so, the Commission is responsible for obtaining an amendment to this language so the investing public is properly informed of such decisions.

Today, the investing public is under the impression a stock purchased is a stock delivered and yet the SEC and the Industry hides the failures from the public's eyes. That can damage the markets through excessive liabilities, liabilities that created the grandfather clause in the first place, but also damage the public's perception of the markets fairness and protections.

Q: How will these rules impact short sellers?

A: This rule should have zero impact on the short selling community, as all short sellers (not market participants) today are required to borrow a share for settlement. Eliminating options for short sales to be executed with a failed trade violates the rules of short selling. Failure to make good on such a borrow or settlement violates the rules pertaining to the sale of an unregistered security. The reality is, large short sellers have worked closely with Wall Street, and taken advantage of this opportunity to add additional dilutions into the marketplace while in other cases, the fails are simply attributable to Wall Street insuring higher profits.

Today a short seller working through firm XYZ can get a short executed with a locate but the trade fails as the locate is not then being borrowed due to high costs to borrow (strategic fail). That locate thus becomes available for the next and the next and the next until somebody actually takes possession.

In other circumstances, and as evidenced by those on the SHO list, the settlement is purely based on the firms executing on behalf of a short seller. Broker-Dealer XYZ may fail a short sale because they cannot locate, within their network a share to borrow, yet Broker-Dealer ABC does have shares available and some other short seller will sell additionally into the market and take possession of that share.

The data analyzed under SHO showed a continuing increase in short positions for threshold listed companies. If all future shorts required mandatory closeout, why were these shares available to borrow not being used to settle existing fails? I suspect it is because the cost to borrow outside the network was prohibitive and thus the fail was conducted for financial gain to the broker dealer.

Between January 7, 2005 and March 11, 2005 10 of the 40 companies (25%) listed on NASDAQ NMS and Small Cap threshold list for both days saw a rise in reported short positions while on SHO. Of those 10, 7 saw sharp declines in the market value with the average decline of these 7 companies representing a 28% loss. Was the fact that grandfathering fails and a lack of forced borrowing a contributor to the market decline as shares remained available for locate indefinitely in order to allow a continuing increase of short sales and fails?

The data of those threshold companies is illustrated in the table below.

		Closing Price			Reported Shorts		
Symbol	**Security Name**	**07-Jan-05**	**11-Mar-05**	**Perf.**	**Jan**	**Feb**	**Delta**
BKHM	BOOKHAM INC	4.19	1.65	-60.62	92,000	114,000	22,000
BLTI	BIOLASE TECHNOLOGY INC	9.92	8.94	-9.88	7,360,000	7,690,000	330,000
ELOS	SYNERON MEDICAL LTD ORD SHARES	24.04	28.25	17.51	1,100,000	1,140,000	40,000
NGEN	NANOGEN INC	6.48	4.1	-36.73	4,520,000	5,040,000	520,000
TASR	TASER INTERNATIONAL INC	22.72	13.65	-39.92	21,100,000	22,060,000	960,000
WATFZ	WATERFORD WEDGEWOOD PLC ADR UT	0.98	0.61	-37.76	52,000	94,000	42,000
ANLT	ANALYTICAL SURVEYS INC-NEW	2.35	2.31	-1.70	203,000	347,000	144,000
BOOM	DYNAMIC MATERIALS CORP	10.13	29.43	190.52	206,000	210,000	4,000
DSTI	DAYSTAR TECHNOLOGIES INC	2.57	7.23	181.32	79,000	95,000	16,000
EEEI	ELECTRO ENERGY INC	9.91	8.89	-10.29	123,000	203,000	80,000

With regards to whether this will prevent short sellers from offsetting price pumps? That is a relative philosophy and one the SEC should tread lightly with. Are short sellers who trade on shares that do not exist at the time of the trade preventing price pumps or are they artificially maintaining a lower valuation and thus manipulating the stock prices down? There must be a balance between supply and demand and a process where you can sell short on little margin or buy at full cost will always lend itself to the lower cost alternative. The SEC, in rule making cannot justify allowing one level of fraud to attempt to offset the potential of another. The problem being, the short selling fraud is everyday and in many securities while the fear of a pump in dump is more isolated and manageable.

Q: How will this rule prevent the opportunity to manipulate through short squeezes?

A: How have present laws prevented the abuses of market raids by short sellers? The SEC's fear of a short squeeze has blinded the agency to the equal and opposite abuses of the bear raid for which the Commission was initially created to prevent. Earlier this year Commissioner Atkins admitted in an "SEC Speaks" public meeting that bear raids exist and that the SEC had not taken adequate steps to address and enforce these abuses. These raids come in play through opportunities created by abusive short selling and settlement failures. The SEC also admitted to such in the original release of SHO calling this "added leverage to manipulate."

Commission Atkins stated; "Fraud in this market manifests itself through old-fashioned boiler-rooms with hard-sell cold-calling; new tactics such as cyber-smear or the infamous voicemail that was supposedly incorrectly left on machines giving a bogus stock "tip; and bear raids composed of an unholy alliance of abusive short sellers, stock promoters, class-action lawyers, and others." It is clear by this proposal that the SEC Division of market regulation still remains focused on the issue of "pump and dump" and questions actions to address the alternative abuse of the bear raid.

In a conversation I had with former Illinois Senator Peter Fitzgerald he discussed investments he had made in which short sellers were abusing the stock. His response to me was, "You need to get a lot of buying in the stock to break them away." In this question, the SEC is considering the ramifications of forcing abusive "raid like" shorts out of a stock and the potential squeeze that may ensue and worries about such tactics. The reality is, a squeeze if one did occur would only put the market back to equilibrium, and tactics like this are defensive in nature after the initial abuse had injured the issuer and the investor.

Short sellers simply claim that management should take their eye off this ball and focus it intently on their business and all will be corrected. This is simply detraction away from the fraud as any stock with excessive short selling abuses is going to have a difficult time improving regardless of the business.

Further thoughts for the SEC to consider, in late 1990's/early 200 our markets saw the results of these bear raids, as higher highs in the dot.com suddenly became lower lows based on the raids. The higher highs were due to uncontrolled levels of fails and short coverings in an exuberant market. The lower lows entered during the crash as those shorts (legal and illegal) piled on uncontrolled as the market later crashed. Settlement failures weighing heavily on the overall markets during this period as the raids caused more panic selling and artificial lows with little market stabilization taking place by the market making specialists whose role it was to prevent such uncontrolled markets.

Q: Should relief be provided to market participants of threshold fails where the trades were made in error.

A: Are you joking? Have you evaluated what these errors did to the markets in those securities? The fact that these "error" represent excessive selling into buyers is not a concern to the Commission? Where are the participant's surveillance systems? I believe that if the SEC is aware of such trades and is presently providing relief that the SEC is in fact aiding in the fraud of the investing public.

Consider an error made by a client in the process of entering an order. Is that client allowed additional graces to address the error? No. The client signs a contract taking full responsibility for the trades they enter and each market participant must also take on such responsibilities. If

a participant is relying on program trading than they run the risks of the quality of such programs, Especially if such trading directly impacts the markets themselves.

There are no guarantees to anybody who trades these markets and for the SEC to provide special considerations to the industry members to free themselves from risk are inexcusable.

Q: Is the definition of threshold security accurate and how should fails be addressed?

A: I suggest that the SEC go back to the March 2004 Short sale reform presented by the NASD. In that proposal the NASD required all fails to be closed out immediately if the fails are beyond 10-trade days. If such action could not be satisfied, the failing member must identify DAILY what steps they are taking to close out the fail and why the fail exists in the first place. The NASD stated unequivocally that "Costs cannot be a factor in justifying the fail" when cause was being presented to the regulator.
(http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_000039.pdf)

The SEC should adopt such strict guidance as it would provide the regulators with a databank of what it is that is causing fails in the system as a means of early indications of future problems. Today the regulators are basing the excuses on what they hear by the members who have rationalized based on convenience without the benefit of actual and regular data to support such rationalizations. This is clear by the verbiage presented by the SEC vs. the data we have seen.

Q: Market Liquidity and will these rules impact liquidity in illiquid markets.

A: I believe the SEC is responsible for clearing defining how liquidity is supposed to operate. Today the SEC considers it acceptable for market members to create liquidity by selling shares into the buyers while failing to provide that buyer a share. But isn't that buyer really interested in buying a share and not the right to own a share later?

Market making in general needs further evaluations to determine how market making takes place, especially in illiquid stocks and whether there is a higher degree of sell side liquidity over buy side liquidity.

As an example of this activity I am providing the trade data of Refco Securities.

In October 2005 negative news hit the stock as the CEO was accused of fraud. The market in Refco immediately collapsed on selling pressure and that collapse resulted in a significant level of fails for that trade day. Over 300,000 fails were recorded at the DTCC on a day where the market collapsed some 50% on 24 million shares traded. Theoretically, a market maker would not be representing the sell side but instead the buy side of the market in such a collapse. But no market maker was willing to slow down the collapse on the buy side and instead the trading resulting in excessive fails.

Using the data below (Fails provided by SEC under FOIA request) and the T+3 guidelines of settlement, trade Volume fails on October 10, 2005 would be reported on October 13, 2005.

	Open	High	Low	Close	Volume	Adj. Close*	Fails
07-Oct-05	28.46	28.65	28.2	**28.56**	169300	28.56	45676
10-Oct-05	20.1	20.25	15.6	**15.6**	24222000	15.6	<10,000
11-Oct-05	15.6	15.61	12.79	**13.85**	17347700	13.85	<10,000
12-Oct-05	11.8	11.9	9.9	**10.85**	35088100	10.85	<10,000
13-Oct-05	7.84	7.9	7.84	**7.9**	2768300	7.9	**313944**
14-Oct-05	7.9	7.9	7.9	**7.9**	0	7.9	257414
17-Oct-05	7.9	7.9	7.9	**7.9**	0	7.9	303645

If Market liquidity is to be considered on the sell side the SEC must firm up the liquidity requirements on the buy side of collapsing stocks.

The recent IPO of Vonage (VG) in which short selling abuses and a lack of market making to flatten out this abuse is now being evaluated by the SRO's. Likewise Baidu (BIDU) went through a similar IPO in 2005 where market abuses and fails damaged the stock right out of the gate. Both companies went immediately to the threshold list and have stayed there since.

Ultimately, former SEC Chairman William Donaldson, when speaking about Hedge funds stated "How much fraud are you willing to accept for liquidity." This statement rings as true for market makers as it does for hedge fund liquidity.

Again, for example:

In 2004 the NASD barred Scott Ryan and market maker Ryan and Co. for illegally shorting stocks for Hedge funds using the market making exemption to cover the trades. (http://www.nasd.com/PressRoom/NewsReleases/2005NewsReleases/NASDW_014364?ssSourceNodeId=5). While the SEC would like to believe this was an isolated event it was not. In fact nothing regarding fraud on Wall Street is isolated except the enforcement of such activities such as this. This fraud resulted in two categories of the market that the Sec is reviewing liquidity and short selling fraud and to both issues the market maker was using the exemption for fraud.

The market maker here in question was using the exemption provided for liquidity to commit short selling fraud for personal gain and to the gain of the hedge funds being supported.

Q: Can the closeout rule presently in place be easily evaded.

A: Yes. Closing out fails is a system dependant on surveillance and presently that process is lacking. In a recent case up in Canada, the IDA fined Union Securities $1 Million for SHO related violations on trades executed into the US markets. In the background to the enforcement action the IDA identified how Union securities was shorting into the US markets through a US market Maker whereby the short sales had not met the initial affirmative determination guidelines and how the short sales, and settlement failures persisted, after the issuers were listed on the regulation SHO threshold security list and after 13 days of persistent fails had transpired.
(http://www.ida.ca/Files/BulletinsNotices/Bulletins/B3531_en.pdf#search='Union%20Securities%20SHO')

Of interest here are several items.

First, the US market maker was responsible for insuring affirmative determination and ignored those responsibilities. To the best of our knowledge this market maker was never fined for this participation in fraud.

Second. The IDA identified that the illegal short sales continued despite the fails exceeding 13 days on threshold securities. In this case, the market maker was required to give up the book due to those fails but not only did they not give up the book but they continued with the selling.

Finally, the fails that had surpassed 13 days had not been closed out as the IDA identified in their complaint. Why not? According to the IDA it was simply due to a lack of supervision. I believe that the fact that the IDA picked up this issue and not the US regulators is a clear sign the US regulators are not up to the task of monitoring the forced closure of fails on threshold stocks.

In addition to such evidence of abuses to this requirement are the abuses of washed sales and ex-clearing trades. By moving the fails into ex-clearing the reporting through the DTCC is eliminated and thus the fails are easily masked. Trade data showing DTCC position changes vs. trade volume will illustrate such activities as DTCC changes in many cases never follow the movements seen by the markets.

Then the final way to circumvent the mandatory closeout would be to take a segregated share in balance and use that share to closeout the fail position. Again, analysis of DTCC positions in a member account or clearing account, and matching those positions to that of known long shareholders has revealed significant discrepancies of companies that do not even show up on the SHO list. While these reforms will not fully address this issue this is something the SEC should seriously consider adding into the matrix of reform.

In this process the member firm representing the short seller will continue to tap into all accessible shares in order to settle and avoid the threshold list. In one case recently presented to me, Penson Financial held a DTCC position representing less than 10% of the shares held by a single individual in that security. And that was just one of many who trade with and clear through Penson. So where did the additional shares go? The delta between numbers would have easily qualified the company for SHO but instead the sell side pressure has taken 90% of the market cap in this growth technology company.

Certainly a better process of segregating shares between lendable and non-lendable shares must be considered.

Q: Would Borrowing to Close-out a fail be a better method than forcing a buy-in to close out a fail?

A: As stated above, the borrow process is already suspect and to rely more on this process in the securities settlement process is irresponsible. A trade is a contract between buyer and seller in good faith that the execution is being done with regard to the best interests of both parties. In the short sale process a borrow is mandatory and yet fails due to financial obligations in the borrow process persist. Recent regulatory investigations into the stock loan process raises even greater concerns about the process in which this operation works, Stock lending now becoming one of the major revenue generators to Wall Street.

The better practice would be to restrict the stock lending to client short sales and eliminate all additional stock loan enterprises including the DTCC stock lending operation. The rationalization to such a position?

The reason Wall Street wants to settle a trade is based on the clearance side of the trade execution. To settle a trade means the sell side firm can receive the funds from the buy-side of the market. Under the DTCC stock loan program the lending of shares in a fail reduces the urgency of the sell-side party to close out the system fail because the money has already transferred. Instead of reducing the sense of urgency via the stock loan program, the SEC should be working to induce the sense of urgency necessary in insuring the safety of the markets.

With the computer networks these markets now have, and with the goal of T+1 or T+0, the DTCC stock loan program has become obsolete and is instead being used as a tool in the naked short sale manipulation of securities.

Ultimately the SEC needs to decide whether the markets of here for the market participants or are here for the investing public. Setting up standards of law that protect the revenues of the members is not always setting up laws that are in the best interests of the investing public and close-outs and stock lending is one area where the two easily diverge.

Correcting the Problem: Market Exemptions

The Capital Markets and the formation of efficient capital markets require some level of induced liquidity. That liquidity can come in several forms but each must be tightly controlled to insure that it does not have more negative impacts than positive. Under the Securities Act of 1934, Congress mandated that the Securities and Exchange Commission create a national system be put in place that insured the prompt and accurate clearance and settlement of trades.

Under these guidelines the SEC took on several initiatives.

One was to formulate a centralized clearance and settlement house and that today is the DTCC. The DTCC is the central depository for all shares and is the gatekeeper for all of the clearance and settlement records across the member firms and sub-tier clearing agencies

The second was to promulgate Rules 15c3-3 and 15c6-1 to set up standards for trade settlement and trade contracts.

Somewhere along the way the SEC and SRO's negated Rules 15c3-3 and 15c6-1 from the settlement process when it came to the market participants (institutions). In doing so the "fair markets" the public expects to participate in has become a marker rigged against them. (Ref 1998 Comment letter to the Commission by a former Securities Compliance Officer http://www.sec.gov/rules/concept/s72499/loverde1.txt)

"However, on the flip side, market makers and broker/dealers have rigged the game so they can play by a different set of rules than the general public and, to date, this ha been protected by the regulatory bodies. These market makers and broker/dealers have done this for no other reason than to line their own pockets, under the sham of maintaining "fairness" in the market. Every day, market pros short sell IPO's, short sell on downticks, and short sell without regard to the availability of certificates, all things done at the expense of individual investors, who do not

have the right to do the same. They do it quietly, without regulation, and without a requirement for disclosure"

Market Making and Options Trading exemptions from trade settlement have resulted in a process where the fox now runs the hen house. These agencies trade on behalf of house accounts and clients and do so in a manner that protects both ahead of the interests of the investing public. These exemptions become a conflict of interest to the markets when the firms carry the financial liabilities on their books and buy-side interests come into the markets.

As an example, the SEC initially proposed under SHO that options traders would continue to be exempt from the mandatory closeout provisions of Reg. SHO. This exemption provided opportunity for those looking to take larger short positions in a stock, but could not because they were hard to borrow, a parallel opportunity. As the short sellers moved into the options market the options market makers simply generated the fails to deliver into the markets from the options side. A study was conducted by the SEC leading into the first release of SHO in which the conclusions to the study identified that the fails created by options market makers were fails done for financial reasons (i.e. it was economically advantageous to keep the fail in the system until such time as the fail become palatable to close out). These fails, however, were having an impact on the pricing of the equity market itself and the investors in that security.

The study by the visiting scholar to the SEC Professor Leslie Boni can be located at http://www.unm.edu/~boni/Fails_paper_Nov2004.doc and was referenced directly by the Division of Market Regulation in the June 2004 SHO Regulation release before the Commission. Today the SEC is now reconsidering this issue (loophole) of options exemptions first brought before them in 2004 for which the SEC ignored the data presented.

- How much of the continued abuses of this loophole impacted the investing public over these past 18 months and resulted in more profitable operations for the market participants?

In one study, Overstock.com, the options market increased dramatically as CEO Patrick Byrne spoke out about the naked shorting issues and began to identify key players within Wall Street that he perceived to be taking part in the abuse. With the stock being hard to borrow for legitimate short selling the Hedge Funds most interested in shorting the stock merely moved over to a compliant options market when options calls were freely executed.

The result of such transition was a severely declining equity market value with equity investors routinely finding their trades failing due to sales executed under options exemptions. These trading exemptions, instead of being closed out routinely, simply accumulated over time while continuing to impact the actual market of the stock.

For example, on April 22, 2005 when Overstock became listed for the second time on Regulation SHO the stock traded with a reported 215,000 FTD's [information provided under FOIA]. The stock was also trading at $34.00/share. These 215,000 shares are the high water mark of grandfathered fails now in the system with all other fails, except for the market exemptions, requiring mandatory closeout.

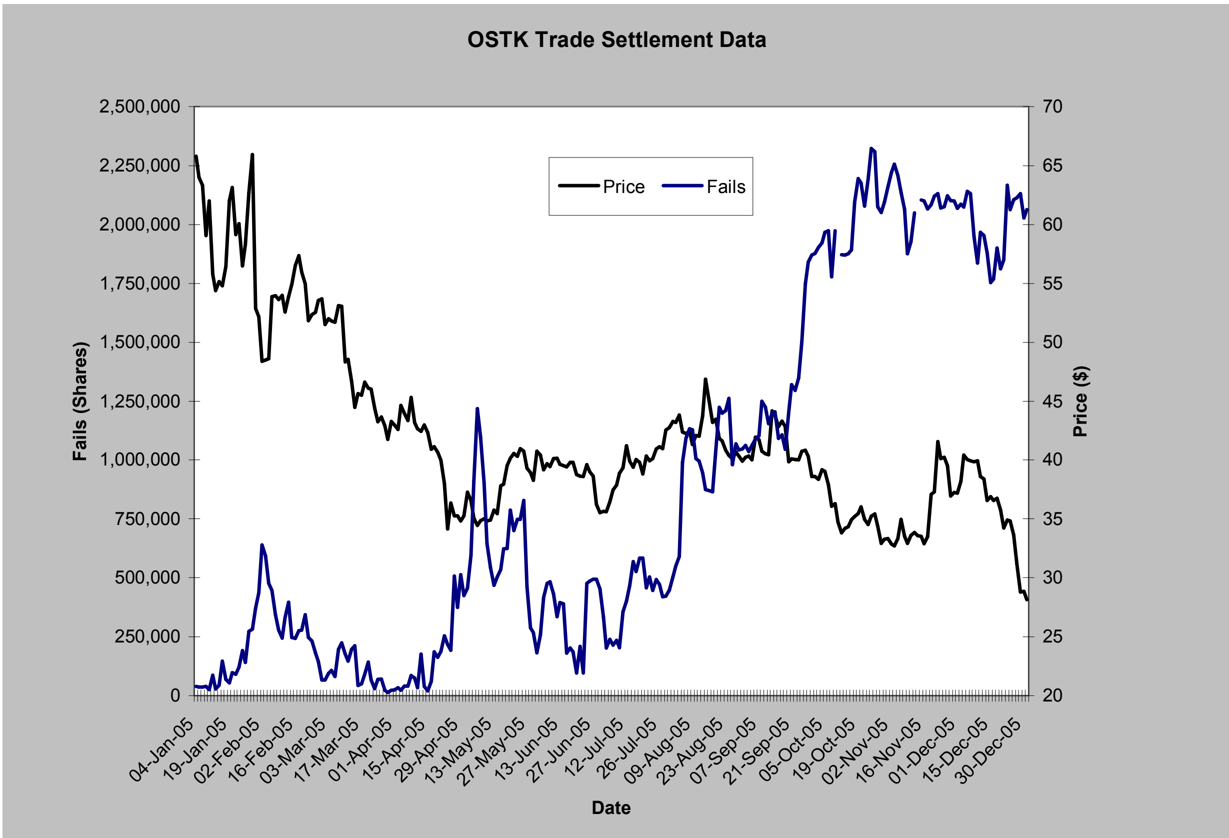
On the recorded trade days that CEO Patrick Byrne and Chairman Jack Byrne executed equity purchases into the markets [Aug./Sept. 05] the FTD's were increasing substantially tallying to over 1.2 million shares by September 7, 2005 ($40.00/share closing price). The tally of FTD's continued to increase throughout the remainder of 2005 and by October had peaked at 2.3

Million shares ($35.00/share closing price) before closing out the year at 2 Million shares daily ($28.00/share closing).

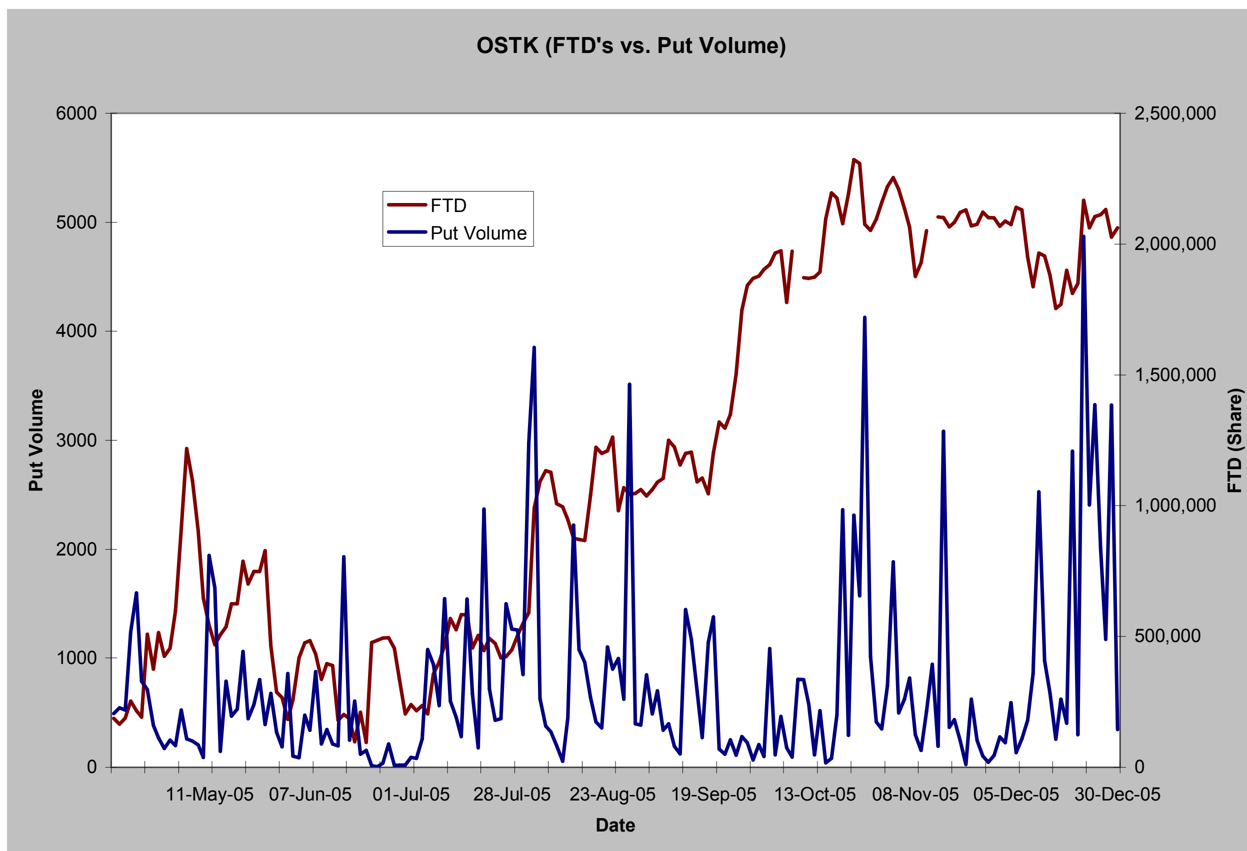
In a period of 4 months the market lost better than 25% in market value while the fails in the system increased by greater than 10% of the public float. The reported short position is now exceeding more than 100% of the overall publics float.

The FTD's now settling in at 10 times the original level of grandfathered fails and yet the regulators found no trading irregularities. The fails, while participating in the general slide in equity value, were being exempted as short sellers who could not gain a locate for a natural short, were using the options market to trade fails, and thus add sell side leverage into the markets.

This data is illustrated in the chart below with the raw data being made available at http://www.investigatethesec.com/20060622.xls. As the casual observer can see, the levels of fails appears directly correlated to the equity value of the stock



- How much of the fails in the options markets transpired as the option term was nearing completion where the fails executed impacted the outcome of "in the money" vs. "out of the money" for the interested parties?



And while the SEC claims that these fails are attributable to options market making, the comparison of Options Puts to the FTD's does not show a direct day to day correlation as illustrated in the chart above.

Conclusions:

The proposed rule changes, while a good start, continue to leave loopholes large enough to drive a super tanker of fraud right through. For far too long the SEC has ignored the abuses of the market members in the settlement process and are now trying to make changes that, while in the right direction for the investors will continue to provide safety from the financial liabilities associated with the prior abuses.

I suggest that the elimination of the DTCC stock lending program be incorporated into this rule change and that the thoughts presented to the SEC by the NASD in March 2004 be seriously considered. In addition, the SEC needs to identify how the issues of ex-clearing fails will be addressed as well as the issues of illegal stock lending practices.

Finally, the SEC needs to show its strength by passing laws that include escalating penalties into the laws. These escalation terms must include the personal accountability of the managing executives and boards of the member firms who routinely come into violation of securities laws. Firms with persistent violations must put there executives positions and abilities to work in this industry on the line.

Recently the NASD fined Citigroup, Morgan Stanley, and Credit Suisse for violation of the research analyst conflicts of interest laws. The violations reached into the tens of thousands and dated back to a period in which these same firms were involved in settlements with the

Securities Regulators and the state regulators in what became a 41.4 Billion Global Settlement. According to the NASD complaint Citigroup failed to comply with the new laws because “The firm's delinquent efforts to comply with NASD disclosure rules were hampered by a lack of effective or timely corporate support, including the failure of the firm to commit adequate funds or resources. Lacking sufficient funds and without a game plan for completion, Citigroup's efforts were characterized in a June 2004 internal email as being "in limbo.” In the terms of the Global settlement all these firms signed a cease and desist order from future violations that were being violated before the ink was dry on those orders.
http://www.nasd.com/PressRoom/NewsReleases/2006NewsReleases/NASDW_016962

Citigroup did not bring its research into compliance with NASD disclosure rules until May 2005, more than two years after the effective date of these rules.” And while Citigroup failed to comply for reasons including the lack of commitment of capital the executives of this firm were receiving considerable salaries for the growing profits of the business.

When executives within firms violate the public trust, and continue to do so for the pure satisfaction of personal gains, their actions must come with severe penalties when caught. Under Sarbanes Oxley we hold the executives personally accountable for the financial reporting of these firms. To instill the value change amongst Wall Street they must feel the urgency from where it counts; wallets and their ability to work in this industry again.

To once again refer back to the comments of a former SEC Chairman “how much fraud are you willing to tolerate for liquidity” and with that, to what impact does this fraud have on the safety of our capital markets, investor confidence, and the financial stability of the largest population of Americans; the middle class.

The SEC has been accused of putting the best interests of Wall Street ahead of the investing public. Now is your opportunity to prove us all wrong. The data I have provided is much of the data the SEC provided under a FOIA request and thus data available to the SEC for review if the interests had been there.

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