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Washington, DC

Commissioners,

Thank you for allowing me to comment.

On September 15, 2006 the SEC will again take the opportunity to review Regulation SHO and the pilot program. I would like to take this opportunity to place focus on the areas that the SEC should consider as it considers the overall effectiveness of Regulation SHO.

Pilot Program:

When evaluating the pilot program the SEC must consider the trading activities of those companies that were highlighted for the program. Specifically, how many of those trading within this pilot program fell into circumstance where the stock suddenly fell on to the regulation SHO threshold security list or qualified for portions of the 5-day qualification phase of SHO? As the securities entered and exited such settlement thresholds, how much of the trading volume was market making activities and how much was short selling client orders? Were market makers and clients selling on the downtick of the stock at the same time? Finally, what was the overall impact to the markets in these securities as this activity was taking place?

The markets today can very easily become manipulated through the process of sell side dominance and bear raids. Selling continuously into the bid is the first step of the bear raid process that eventually leads to panic selling. Even in highly liquid stocks the impacts can be seen although to a lesser extent. Since sellers panic on a collapsing stock, it is far easier to create that sell-side panic than it would be to induce buy-side exuberance.

Did the opportunity for short selling into a downtick create sell-side panics? Did others take additional opportunities to sell into the bid with shares that did not settle where the trade was flipped quickly for short-term profit taking? Trades of this nature would only temporarily qualify the security for the SHO threshold but could have impacted greatly the overall market cap of a stock.

Threshold Lists and Grandfather Clauses:

The SEC has publicly stated several times that regulation SHO has been successful in that the number of fails in the system and the number of issuers listed on the threshold security list has been reduced by 34%. Unfortunately, this is a very arbitrary statement. It is arbitrary on two fronts:

First, in the first 4 months of Regulation SHO the level of settlement failures had dramatically reduced from the months leading into the new laws. But what is not being considered is that In December 2004 the number of settlement failures was 32% higher than the numbers were in June of 2004 when SHO was first passed (Data used was presented by SEC under FOIA request). By May 2005 the average daily number of settlement failures was 24% below the number represented in June 2004 (http://www.investigatethesec.com/NASDAQ_SHO_EVAL.xls).

This data implies that the first 4 months of Regulation SHO provided for the most impact on trading and that since May 2005 very little additional progress has been made. Based on the grandfather clause allowances and a lack of regulatory activities, it appeared that much of the industry found little need to change their habits and therefore proceeded on with business as usual.

Second, the manner in which companies come off regulation SHO, and how fails are erased is as important as the removal itself.

Provided under several FOIA requests was information on several target SHO companies. The companies I requested this information on were known abused issuers over recent times. What was interesting is that there were several different methodologies on removing fails in the system but for each the result was strikingly similar.

Cal-Maine (CALM) started on Regulation SHO in January 2005 with 22% of the public float represented as a Fail to Deliver (http://www.investigatethesec.com/Calm_Maine_FOIA.xls). These Fails were all grandfathered by the guidelines specified in Regulation SHO. Interestingly, the reported short position was nearly 80% of the public float at this time as well.

With each month that passed from January 2005 when Cal-Maine was first published on Regulation SHO to September 2005 when it was finally removed four sets of metrics correlated precisely. The level of FTD's in Cal-Maine slowly decreased, the level of reported shorts decreased, the average daily trade volume decreased, and the stock price decreased. In total, the FTD's decreased from 2.3 Million shares to 300K shares, the reported shorts decreased from 8 Million shares to 1.4 Million, the average daily trade volume decreased from 400K/day to 70K/day, and the stock price had decreased from $12/share to $6/share.

In this example, Regulation SHO worked in lowering fails in the system but at what expense? Over 2 million fails were allowed to slowly matriculate out of the stock in a manner that clearly identifies market abuse. Trade volumes, sell-side trade volumes were used to drive investors out of the stock.

Additional abusive trading to clear fails at a profit can be seen evaluating Global Crossings FTD data as well (http://www.investigatethesec.com/20060624.xls). While the final results of Global Crossings are not yet known, since at the time of this comment letter Global Crossings remains a threshold security as they have since January 2005, what is clear is that the original fails grandfathered by the SEC are slowly being covered at a profit as the stock is being worked lower and lower in market cap.

Interesting in the Global Crossings data were trading periods when the stock began to see positive interests and yet the FTD's only increased. The FTD's being used to hold the stock back until it crashed back down under the selling pressures. Again this is more suspect evidence of market abuses by the member firms to protect their liabilities associated with fails already on the books and free from closure via the grandfather clause.

And the final example of the grandfather clause failing is Overstock.com. In this case the FOIA data presented evidence of an opposite affect. The data illustrated a continual increase in fails as the stock price was being driven down (http://www.investigatethesec.com/20060622.xls). In the case of Overstock, the fails increased from a level grandfathered on April 22, 2005 of 216,000 shares to new highs of 2.3 Million shares by December 2005. All but a maximum of 216,000 being grandfathered and yet the level of fails increased 10-fold under the new laws as the stock depreciated some 50%.

If SHO were being effective, the high water-mark identified in January 2005 would show significant reductions by now with a goal being zero companies on SHO and very low and temporary levels of FTD's in the system. Instead there are these cases of extended and excessive fails and evidence of abusive activities being used to protect these FTD's.

Regulatory Enforcement:

The most alarming issue with SHO is the lack of regulatory enforcement regarding abuses and violations.

Under SHO, any Broker-Dealer must cease all short selling of securities if they, or their clients, have fails in threshold securities that exceed 13 trade days. If a market maker or specialist owns the fail they must "give up the book" until the fail is covered. This is not a flagged regulatory event but an event that is to be taken by each individual firm under the "honor system". Unfortunately this honor system is worthless.

On April 16, 2006 the Canadian Regulator (IDA) brought the first enforcement case against Regulation SHO violations regarding the honor system. In this case the IDA sanctioned Union Securities for shorting US stocks in Canada without meeting affirmative determination and "continued to short the stocks into the US Markets after the companies were listed on the threshold securities list and after the initial fails had already exceeded 13 consecutive days." In addition, the IDA claims that Union Securities was using a US Market Maker throughout this period, which places the market maker in violation of the "honor system."

Regulation SHO also implies that fails greater than 13-days on threshold companies must be closed as quickly as possible. In the case of Overstock.com, the April 22 date with 215,000 FTD's had been reduced to 95,000 in June 2005 before skyrocketing to over 1 Million in August and 2 Million in October. With 95,000 being the new watermark for grandfathered fails, how could Overstock continue to grow at multiples now exceeding 20times the level of grandfathered shares? Have any Broker-Dealers stopped trading the stock short without insuring guaranteed delivery? Where are the mandatory closeout provisions implied in Regulation SHO and the regulators enforcement of those provisions?

Conclusions:

The SEC cannot judge the success or failure of Regulation SHO merely by the level of companies or fails in the system. The SEC instead must judge success or failure by the method in which fails are being created and how fails are eventually being closed out. In special events like Refco, we saw the use of fails in a collapsing market to raid the stock (http://www.investigatethesec.com/20060602.xls) and the NYSE is investigating similar type abuses in the Vonage (VG) IPO where Vonage immediately became SHO qualified and has remained there months later. Baidu (BIDU) trading at the IPO saw a similar market abuses simply less abusive on day1.

The investing public has a right to the prompt settlement of every share purchased with the settlement failures being nothing greater than temporary market exceptions. SHO, and the data provided 18 months later, illustrates that for Wall Street the settlement failure remains a standard practice used to manipulate and not the exception to trading hiccups.

Settlement failures are the sole financial liability of the institutions and thus, allowing the institutions free opportunity to settle their financial liabilities without restriction is like allowing the fox to guard the hen house. The institutions never disclose to their clients this liability they carry and thus never let the investing public aware of their future needs or intentions. A former VP of a now closed Market Maker once stated that he refused to buy in a fail at a loss, "I am here to make a market not lose money."

What is clear here under SHO is that this is a belief held by many within the industry. If a fail must be settled, the Institutions will work the market to make that fail a profitable settlement.

For the safety of our capital markets, the SEC must seriously consider the rulemakings of SHO and begin to address the loopholes created within SHO and the loopholes being used by the industry professionals. The spirit and intent of the Securities Act of 1934 specifically addresses the perils of extended and excessive settlement failures and Regulation SHO has done nothing to enforce that spirit of the law.

The investing public has a right to equal protection under the law. SHO denies the investing public not only the rights to profit but also to protect that profit for abuses from within the industry mechanics when it allows the Institutions free reign to pick and choose when and how they will settle trades.

I urge the SEC to remove the grandfather clause of Regulation SHO and to re-institute the tick-test into the markets until such time as the issue of trades and trade settlements is completely addressed without the loopholes for abuse. The investing public comes above all else and presently SHO has put the investing public in harms way.

David Patch