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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303

February 14, 2007

File No. S7-20-06:

Dear Ms. Morris:

Here are my comments on the proposed changes to Rule 105. In brief:

- The use of the current definition of short sale is inadequate because many abusive practices occur with sale transactions that are not classified as short sales under the rule. In particular, the proposed rule does not cover many abusive transactions related to the sales of shares received from convertible debt or from equity lines of credit. Instead, the rule should ban all hedging transactions before the offering.
- The scope of the rule should be expanded beyond offerings made on Form 1-A due to the many abuses in those offerings.

The proposing release asks about the definition of a short sale. Under Rule 200(b)(2), if a person has an "unconditional contract" to purchase the security, then the sale is not treated as a short sale. Similarly, under Rule 200(b)(3), the holder of a convertible security that has been tendered is also not treated as a short sale. These exclusions can be abused in the following abusive situation found in some PIPE deals:

Company issues a convertible security or receives an Equity Line of Credit (ELOC) from an investor such as a hedge fund. Under the ELOC, the investor commits to purchase shares from the issuer at such times as the issuer decides to sell shares. The issue price is typically set at a discount to the market price during the five business days after the issuer notifies the investor. Some convertible debt issues act in a very similar manner in that the issuer has the option to pay the interest and principal in stock, at a conversion price based on the stock price over the five day period after the interest is due.

The investor can lock in an arbitrage profit by dumping the shares on the open market during the five day window when the price is determined, even though the shares have not yet been received. Because of the unconditional nature of the ELOC or convertible tender, the sale is not classified as a short sale for the purposes of the proposed rule or Regulation SHO. The investor has thus taken no market risk and yet pockets the entire discount. Unlike a traditional offering, the seller hasn't engaged in any substantial marketing efforts, but just sells the shares into the market. Furthermore, such sellers, relying on the 35 day grace period in Rule 203(b)(2)(ii), may fail to deliver the shares on the usual T+3 settlement date, exacerbating failure to deliver problems.

Such an arrangement is abusive in that the new shares have been sold to unsuspecting purchasers in the open market. Even if the issuer puts out an 8K, the filing usually occurs after the shares have actually been issued. This means that the selling has already occurred in the market along with the concomitant price drop. The taking down of part of the ELOC (or the decision to pay required debt service with stock) is a material event, as it usually indicates that the company needs cash. Selling such stock before the announcement is trading based on material nonpublic information and presumably a violation of the antifraud provisions in 10b-5.

These transactions have the same economic effect as a secondary offering: The company gets cash (or conserves cash by using stock to pay debt), and new shares are sold to the public. Yet the SEC filings of the issuer and/or the investor are generally incomplete with regard to the substance and timing of the transactions.

To combat these abuses, the SEC should explore the following:

- Crack down on the incomplete disclosure surrounding these deals and insisting on clear filings written in plain English before the shares are sold to the public. Even if the shares have previously been registered, there should be an 8-K filing *before* the newly issued shares can be hedged or sold.
- Expand the scope of the regulation to cover abusive practices surrounding the distribution of new shares that are not issued using Form 1-A.
- Step up enforcement actions against firms and individuals that are trading on material nonpublic information before the announcement of such transactions.
- Consider explicitly banning any kind of hedge transactions, not just short sales, in the five days before the shares are issued. For the purposes of this regulation, a hedge transaction would be any transaction that, combined with the shares received in the offering, results in a position with *de minimis* risk. This would include not just the abuses mentioned, but also similar abuses involving options, single stock futures, equity swaps, or other financial engineering techniques.

Cheers,

James J. Angel, Ph.D., CFA