

March 19, 2009

Office of the Inspector General
Securities and Exchange Commission
100F Street NE
Washington, DC

RE: OIG report on Practices Related to Naked Short Sales and Referrals
 Release No. 34-58773; File No. S7-30-08

Inspector General Kotz,

I would like to personally thank you and your staff for investigating the SEC's response to naked short sale complaints. Your team's analysis of the situation coincides directly with that which has been perceived to have been happening for decades. That being, the SEC's Division of Enforcement has neglected their responsibilities in responding to investor concerns when it involved short sale abuses. It is because of this perception that there exists such a lack of interest in investigating investor complaints that most complaints never get filed in the first place. This is not limited to just issues involving short sale abuses but fraud in general.

The SEC wants the case handed to them and if it is not, they ignore the complaint.

I would like to welcome you and your staff to the "small but vocal cadre of advocates" whose intent it was to expose not only the mechanics of fraud but the very individual preconceptions and acts of negligence taking place within the agency responsible for investigating such fraud. I would suspect that soon you too will be dismissed by agency staff as a nutcase just as quickly as the SEC staff dismissed your most recent report on short selling investigations. Please do not fret however, it is a badge of honor to be considered out of touch by a staff of SEC attorneys who have lived their lives being out of touch with the public and captured by the very people they regulate – the industry.

At this time I would like to debunk the SEC's response back to you if I may and try to use the very data they fail to recognize when dismissing these claims.

I. Report can cite to no bona fide studies or empirical data regarding the practice's market impact. The Division of Trading and Markets debunks the theory that NSS creates "counterfeit" or "phantom" shares.

Let's first start with the agency's diversionary tactic of citing the OIG's failure to provide a bona fide study or empirical data. Clearly the Commission is not insinuating that it should be the responsibility of the OIG to run such analysis or that such analysis is even the focus of the OIG study itself.

As I read the OIG report, it is not in support of claims that naked short abuse exists or does not exist, only that it is not being pursued by the agency investigators. Whether a study exists affirming or refuting such trade strategies is irrelevant to the fact that less than 3% of all complaints citing naked short sale abuse are followed up where an investigation is initiated as a naked short investigation. The OIG may wonder why the Commission took such a strong and irrelevant position against your study. I certainly do.

Regarding the study itself or lack thereof, one does not exist because the SEC has chosen not to conduct one. The Office of Economic analysis admits such and admits that while such a study would be informative, they do not have the staff or the interest in conducting such an analysis.

Doesn't this then invalidate any global picture the Commission can make if they are operating without all the facts?

A bona-fide study into naked short sales and the abuses of naked short sales must come from the regulators and most notably the SEC. Data that would be used to comprise such a study would need to be micro-trade data and not the biased and manipulated macro crap coming out of the Office of Economic Analysis today. The OEA analysis that has been provided has been deeply flawed in their assessments, and proven several times and thus to use such studies as a validation that problems do not exist is simply irresponsible. Only investigations and evidence can validate a study and such investigations have admittedly not been made.

To understand the impacts of naked short selling in a specific targeted market trade tickets need to be pulled, markets recreated, and settlement information obtained and correlated. Analysis of exactly how and exactly when a naked short is executed must be known relative to the exact market at that time. Was the naked short executed as a bona-fide market making activity and did the executor of that trade have preexisting position where the naked short protected that outstanding position? How was the short covered and when? Were common players involved including market makers and hedge funds? Was the options market or multiple locates through split orders used to execute more trades than would otherwise be allowed?

All these critical points in an analysis are recognized as proprietary information with access limited to regulators and in many cases the SEC alone. None of this information is information that would be available to the public, including economists, and therefore can only be a study conducted by the SEC. Only the SEC has access to this entire scope of data and only the SEC has the ability to match the records at the DTCC with that of the books of all broker-dealers in a single snapshot in time.

The fact that the SEC has not even attempted to initiate such an effort and yet uses a lack of such a study against the OIG is incredulous.

II. As the Commission noted in its October interim final temporary rule release adopting Rule 204T, more than half of all fails to deliver and 70% of all fails to deliver positions are closed out within two settlement days after T+3 (two days late).

The Commissions reported cited within this text fails in a most significant manner. It fails to identify why these trades failed, even if they failed for only two days, and it failed to identify what impact such trades had on the actual market in trade. A bear raid in today's market can last as short as an hour or take as long as months. All a market needs is a sign to panic and the rest is a guarantee.

In 2003 the SEC first proposed Regulation SHO and in the draft reform the SEC stated "More significantly, naked short sellers enjoy greater leverage than if they were required to borrow securities and deliver within a reasonable time period, and they may use this additional leverage to engage in trading activities that deliberately depress the price of a security."¹ There was no discussion identifying a minimum time period necessary to engage in this manipulation, only that the leverage obtained was adequate enough to drive down the markets value.

¹ <http://sec.gov/rules/proposed/34-48709.htm#IIA>

The OIG should consider carefully whether these SEC studies being conducted, under tax payer expense, are adequate enough to root out the serious issues involved in the very premise behind the study. Did the SEC investigate cause for the failures or were failures lasting only two days simply rationalized away as normal market activities? Is the metric of time or quantity the catalyst behind the leverage being cited in the SEC document?

III. While the Commission recently strengthened the close-out requirements because it is concerned about the impact of persistent fails on market confidence, these fails to deliver are not necessarily the result of illicit activity, such as abusive “naked” short selling.

The SEC continues to refer to the word persistent in correlating naked short selling to fraud. Fact of the matter is, most enforcement actions taken by the SEC and SRO's involve failures to deliver that were not “persistent” by the standards identified by the agency. On those occasions when a PIPE investor naked shorts ahead of the PIPE, and uses shares issued in the PIPE deal to cover the short sales, the period of failure is relatively short and thus not “persistent”. The periods can in fact be within the same levels the Commission has deemed accepted business practice and ignores when such flags are being raised.

In fact, persistent failures would be the very type of naked short sales executed against Eagletech back in the early 2000's where the fails to deliver floated on the books of the clearing firms for nearly a year. The evidence of this very existence came through a discovery filing where the SEC was obligated to hand over all investigative materials to Eagletech.² Contained within that material were the trade data that identified common parties involved in naked short selling and persistent failures to deliver.

In this case, the SEC failed to take action against the short seller s or broker-dealers colluding with the short seller to manipulate the market in Eagletech. Why is that? Why did the SEC ignore the crook and shoot the messenger?

IV. The ECC receives all sorts of communications. Investor complaints run the gamut from the painstakingly specific and well-researched to the speculative and fanciful. So-called “Level II” complaints – that is, assertions of market manipulation or distortion from retail investors based purely on observations of private computer terminals – rely on simple trading snapshots and are really no more reliable an indicator of fraud than a dart tossed at a dartboard full of company names.

I would ask the Commission exactly how a retail investor is supposed to come into access of the specific detailed analysis the SEC would require to be taken seriously. And what is that data?

In the only significant case brought by the Commission, Rhino Advisors was fined and barred for manipulating the market in Sedona.³ This case was investigated by the Commission only after a former director of the Commission and a member of the Board at Sedona used his clout as a former Senior Staff member to get the case pursued. Without the connections there would have been no case and no settlement.

What Sedona did to aide those involved at the SEC was illustrate through the use of Level II trade data what was taking place and in fact trained SEC attorneys on how to read the data. Something the attorneys were not trained to do at the time and possibly even to this day.

² Eagletech Response in SEC Administrative Proceeding <http://www.investigatethesec.com/drupal-5.5/?q=node/626>

³ SEC v. Rhino Advisors <http://www.sec.gov/litigation/litreleases/lr18003.htm>

Ultimately, the only successful major SEC case involving naked short selling, and the singular case the SEC uses when referring to their diligence in this area, was initiated through the use of evidence obtained by the only methods available to the public, Level II trade data. The fact that the SEC now dismisses this approach is quite concerning as it leaves investors now with zero options.

If such is the case, the SEC should notify the public of which complaints they will no longer investigate so as to not waste the Commissions or the investors time and efforts.

V. Complaints that contain the most facially compelling information regarding possible violations of the federal securities laws, the material most likely to trigger Enforcement investigations leading to filed actions. This is accomplished by focusing on complaints with a high likelihood of accuracy and credibility (like those of purported insiders or scam victims), those whose information can be readily vetted (i.e., visible price swings in a possible manipulation or insider trading allegation), or those involving demonstrated, immediate investor hazard in the current market environment (Ponzi schemes, improper sales of auction-rate securities).

Complaints that contain the most facially compelling information, what would that be in a case involving naked shorts? Could it be complaints that provide e-Mail notification from broker-dealers and clearing firms that admit they can not settle the trades to make their shareholders whole?

Complaints filed with the SEC regarding naked shorting in jag media exist. I know they exist because I filed them. I filed them with spreadsheets of data showing unusual trade patterns and I filed them with documented evidence that something was wrong with the settlement process in these markets. In fact, in one case it was not just I that filed a complaint but Senator Paul Sarbanes did the same on behalf of one of his constituents using the same evidence I had.

In a September 2004 response to the Senators inquiry, Deputy Director in the Division of Trading and Markets James Brigagliano stated in his memo that *"We note that the failures cited by Ms. XXXXX in attachments to her letter do not appear to be the result of naked short selling abuses but rather from an action taken by the issuer, Jag Media Holdings, Inc."*⁴ The letter goes on to cite the issuers June 2004 corporate action⁵ in moving to custody-only trading.

The problem with the SEC's response is that it is fictitious. The statements made by Mr. Brigagliano are purely false and misleading. It is impossible for the failures cited in the documents attached to the Senators inquiry to be related in any way to the corporate action of June 2004. The documents attached in the inquiry are e-mails from broker-dealers and clearing firms and are dated April 2003.⁶

Did the SEC ever investigate the background of those e-Mails as to why broker-dealers and clearing firms were writing the company regarding delivery failures or did the SEC already hold a preconceived opinion in the matter thus disregarding any and all evidence submitted? If this type of data is not of enough consequence to initiate an SEC investigation, what exactly is the public to offer as evidence?

⁴ SEC Memo to Senator Sarbanes September 15, 2004 <http://www.investigatethesecc.com/drupal-5.5/files/Sarbanes1.pdf>

⁵ Copy of UPC Notice for June 4, 2004 Corporate Action <http://www.investigatethesecc.com/drupal-5.5/files/JagUPC.pdf>

⁶ Settlement Failure e-Mails <http://www.investigatethesecc.com/drupal-5.5/files/SettlementFailures.pdf>

As for that corporate action the company executed in attempts at obtaining additional information necessary for the SEC to take the concerns seriously, the SEC shut down that venue in 2004.

In June 2004, the same June 2004 as the Jag Media Holdings corporate action to move to "custody-only" trading, the SEC introduced proposal Release No. 34-49804; File No. S7-24-04⁷ prohibiting issuers from taking action towards custody-only trading. The SEC proposal and the Jag Media Holdings action took place on the very same day, June 4, 2004.

In the SEC proposal release the SEC states *"Issuers imposing these restrictions, sometimes referred to as "custody-only trading," frequently state that they are imposing ownership or transfer restrictions on their securities to protect their shareholders and their share price from "naked" short selling... The Commission does not believe that naked short selling concerns should or can be addressed by issuers attempting to control the ownership or transferability of their securities that trade in the public market."*

By evidence, the SEC has admitted in their response letter to you that while they have taken on the responsibility of protecting such issuers, they do not take such issues seriously enough to actually investigate or even properly study the investor or issuer concerns.

This past week the SEC brought up charges against Paul M. Gozzo and PMG Capital, LLC of Jupiter, Florida, alleging that they violated the federal securities laws by manipulating the markets of numerous microcap stocks in 2006 and 2007.⁸ In the complaint the SEC alleges that Gozzo a.) engaged in "bid support" by placing orders for shares at prices below the inside (highest) bid to absorb sell orders and create an artificial floor for the stocks; b) traded in multiple accounts through multiple brokers to give the false impression that there was greater demand for the stocks than truly existed; and c.) coordinated trading among a group of individuals for the purpose of maintaining stock prices.

In a naked short scheme of similar tactic would be used to cap off any upside momentum and drive away investors. Such tactics could in fact require naked short sales to persist for longer than the standard 3-days but certainly not to durations considered persistent. Factoring in the T+3 and add in the significant level of fails that persist for a mere 2 days, the scheme could be executed and covered within a window of one week. Certainly long enough to generate profits.

But while the SEC will seek out cases involving the likes of Mr. Gozzo on the long side manipulation, this same agency is willing to rationalize away failures that could be red flags on downside manipulation. To consider that this doesn't happen from both sides of the market is irresponsible and negligent. I wonder, for how many days did Gozzo provide the bid support?

Finally, I would like to point out the arrogance in the undertone of the response letter the OIG received from the Division of Enforcement Staff member regarding your investigation. Such arrogance and unwillingness to recognize that your opinions are not vastly dissimilar to that of the public's is a failure in social responsibility and business management. The response was childish at a time that the country needs and demands accountability and out-of-the-box thinking from the agency.

I read their response and could not stop considering that the term naked short could be replaced with so many others if we were to look back on the SEC's history of failures.

⁷ SEC Rule on Custody-Only Trading <http://sec.gov/rules/proposed/34-49804.htm>

⁸ SEC Litigation Release <http://sec.gov/litigation/litreleases/2009/lr20957.htm>

Henry Blogett and the research analyst's debacle was one that the SEC failed to respond to when complaints and concerns surfaced. Peter Scannell from Putnam came to the SEC with concerns regarding market timing and those concerns were quickly dismissed as irrelevant. His concerns resulted in billions of dollars in fines levied against our largest financial institutions and hedge funds but only after state regulators took his concerns seriously. And how can we not identify Harry Markopolos and the Madoff ponzi scheme in this debate? Markopolos came forward with the material the SEC claims is all they will respond to and they still missed target. Heck, they missed the entire barn.

Of course there are so many others to speak of but no need, the message is the same. The SEC, a captured regulator, is most likely to take a cautionary view of complaints and dismiss them without investigation instead of performing the due diligence that is expected of them. Had trade tickets been pulled in the Madoff investigations early on when it was first identified the victim list would be much smaller today. Similarly, had the Commission initiated studies into select targeted companies and pulled the trade tickets on the settlement failures they would today have that bona-fide study that once and for all closes out this issue.

“But there is hardly unanimity in the investment community or the financial media on either the prevalence, or the dangers, of “naked” short selling.”

Clearly this individual does not understand the role of the Commission.

The Commission is not supposed to make market regulation and market enforcement a popularity contest; they are supposed to maintain laws that protect all investors. Something the general counsel unknowing accused the Commission of not doing when he opened up a December 13, 2004 conference call on regulation SHO by stating *“To give you that brief introduction in Reg SHO, the history (of) how we got to where we are today. For the past few years we have been hearing from many different regulators regarding their concerns about the increase in the level of fails that they are seeing. They believe, and they have stated on numerous occasions, that one of the primary causes of the high level of fails was that various participants in the short sale process, prime brokers, executing brokers, clients, were not following already established rules.”*⁹

Simply because a majority of the member industry, working alongside the financial media, does not agree to the impacts of naked shorting that does not make this issue does not exist and that it should go away. The financial media never exposed Bernie Madoff or Allen Stanford. The media was as complicit in hyping garbage stocks in 2000 as Henry Blodett and the financial media has been directly linked to short selling hedge funds when it comes to sock-puppetry.

The fact that the SEC closed their investigation into Gradient Analytics only to see that Gradient settled with Overstock.com out of court, and admitted to their practices in the settlement, seems un-nerving. Or the fact that Fairfax Financial has unearthed thousands of e-Mails that link analysts, short sellers and business writers in a conspiracy group should concern the SEC Division of Enforcement but it apparently does not. They spoke of none of it in their feedback, limiting their memo to distasteful and irresponsible rhetoric.

Inspector General Kotz, I applaud your efforts regardless of whether they are considered a success or failure on this particular issue. Your efforts go far beyond the issues of naked short selling by exposing the general flaws in the SEC's general behavior and business practices when it pertains to investor concerns. Clearly 'We the People' are of little significance to the SEC until it comes to generating tax dollars to pay their bills.

⁹ Audio of Bear Stearns Conference Call <http://www.investigatethesecc.com/drupal-5.5/?q=node/153>

The fact that the SEC choose to shoot the messenger ironically places you in the very same position the general public has lived for many years; disrespected and ridiculed. Welcome to the tin-foil hat team. Hopefully the SEC's response to your investigation will instill an even greater drive by your team to change this SEC culture by using all the authorities made available to you and your office.

My best to you and your staff,

David E. Patch

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