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Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609
Via www.sec.gov

Re: File No. S7-12-06

Secretary Morris:

Introduction

I am a Ph.D. economist doing research and consulting in finance and economics. I am formerly Director of Transfer Agent Services for Depository Trust Company in New York, and Operations Manager for Pacific Depository Trust Company and Pacific Securities Clearing Corporation in San Francisco. I also was Senior Advisor for KPMG on the USAID Capital Markets Project to design and implement trade clearing and settlement operations during privatization in Russia. Over the last three years I have been a paid advisor to companies, investors and law firms on the issues addressed by Regulation SHO. My comments will reflect my expertise in economic analysis of law and market efficiency, plus securities processing operations.

I support the Commission's efforts to keep from creating new grandfathered fails when an issue briefly comes off the Threshold list. Although many people were aware of failures to settle that existed either before the Regulation was effective or before the issue qualified for the Threshold list, it was careful review by Commission staff that revealed this additional source of unattended settlement failures.

I also applaud your request for comments from transfer agents on the impact on proxy voting rights and processes. These gentlepersons have been trying for many years to bring attention to the damage done to proxy voting rights through short sales and stock lending. Since my expertise extends to the securities transfer industry, I will address comments to that issue as well.

In the first two sections, I begin with a discussion of the impact of settlement failures on capital market efficiency and the impact of Regulation SHO on economic incentives. In Section III, I address the relationship of short sales and stock lending to proxy voting rights. Section IV offers a specific discussion of the systemic causes of the problems generally attributed to "naked short sales" by the vocal group of companies and investors now demanding action. In Section V, I outline a primary argument for the roles States can play in protecting investors and companies. Sections VI and VII argue in favor of

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increased transparency at DTCC and SEC, respectively. Finally, Section VIII points out a grammatical error in the proposed text and some factual errors in the subject file.

I. Fails Disrupt Market Efficiency

Not only the Commission, but also exchanges, and SROs are charged with a duty "to remove impediments to and perfect the mechanism of a free and open market."[1] Economic efficiency is violated when trade settlement fails. At the risk of being pedantic, I believe it is useful to point out some required elements for efficiency in capital markets. In economics, efficiency means that 1) Resources are allocated where demand is highest; 2) No seller effects prices, so each seller has the incentive to cut costs in order to raise profits, thereby providing for the efficient use of allocated resources; and 3) Every buyer pays the same price, thereby achieving efficient distribution.

The three elements of economic efficiency are violated by settlement failures in this way: 1) The supply of shares is allowed to exceed the demand: when purchased securities are not delivered, an entitlement to the same share may be sold a second time either through intentional manipulation or poor record keeping; 2) sellers have no incentive to reduce transaction costs because they are not required to complete transactions; and 3) a buyer who purchases shares that go undelivered at settlement has paid a price that is out of synch with the market; that is, when payment occurs on t+3 and share delivery is at t+13 (or worse) there is a temporal distortion in profit and incentives.

Investors have no way to purchase equity securities except through a broker-dealer who may be allowed to fail at settlement. A key element in free-market efficiency is that no one is forced to accept the sellers' terms or go without. When that happens, efficient allocation and distribution are harmed, resulting in the introduction of price differentials so that investors buy less than they would at equitable prices. In consideration of the promotion of efficiency and competition (section VIII, p. 40) [2], the proposed amendments will promote price efficiency but only to the extent that the original regulation left the door open to inefficient market operations through the institutionalization of failures to settle.

Beyond the ethical implications of imperfect knowledge between bargaining parties, it is a requirement of efficient capital markets that all participants are using the same information set. When one participant is allowed to fail to deliver securities on selected trades, then that participant has private information that is not available to the rest of the market. By providing any exceptions to close out requirements, the Commission is institutionalizing inefficiency in the capital market.

This is not to say that market makers should not be permitted "to sell short threshold securities in order to hedge options positions," as the Commission expects the market to work. Rather, the problem of fails being permitted strategically to one participant and not to another, whether the failure is the result of short, long or hedge transactions, creates an

[1] Exchange Act (1934), Section 3(f)

[2] Page numbers throughout this document refer to the .pdf version available at SEC's website.

additional imbalance in the information sets that are required to be identical for all participants in efficiently functioning capital markets.

Regarding the length of the phase-in period (“e.g., 60 days instead of 35”, p. 11) the economic tradeoffs associated with any delay in implementation are the reduction of economic efficiency which suffers when fails are permitted and which suffers further when fails are permitted to persist. The shorter period is always desirable from the standpoint of efficiency.

In the context of options positions, the file discusses “a sufficient amount of time to allow a fail to remain that results from a short sale by an options market maker to hedge a pre-existing options position that has expired or been liquidated” (p. 20). Although I have no practical experience with options markets, I am a trained economist. My argument against allowing fails for these instances is similar to that for all fails: Every market transaction requires completion for the analytical framework to fully obtain. The counterparty to any market activity is operating under the assumption that the trade will be fulfilled, including the delivery of securities at settlement. The counterparty in an options transaction is specifically dependent in their financial analysis on the impact that the market maker’s activities will have on supply, demand and price for the option and the underlying security. In this case, the damage to the counterparty goes beyond the lack of information about fails. They incur further damage when expectations of market reaction to the market maker’s activities do not occur due to the fact that the transaction was not completed as agreed.

I agree with the Commission that new data processing and communications techniques should create the opportunity for more efficient, effective, and safe procedures for clearance and settlement. However, one might be tempted to equate automation with efficiency; and this would be a grave error. Our problems will not go away with improved technology and shorter settlement cycles; they will only get worse. Today already, a trade riddled with inaccuracies can be passed right down through clearing and settlement without any human intervention. This must obviously be the case if the Commission equates fails with trade errors. For capital market efficiency to exist in the U.S., someone will have to enforce trade settlement, including securities delivery.

I think that allowing “the cost of closing out the fail [to] be a part of the economic cost of making a trading error” (p. 14) is a brilliant suggestion on the part of Commission staff. If I purchase a service, I will pay for it. But if the service provider makes an error, they should not come back to me (the investor in this case) to pay for their mistakes. Enforcing the cost of closing failed trades to the erring party will add to real economic efficiency as those firms that make too many trading errors will be driven out of business, and those that are better at executing trades (all the way through to settlement) will survive.

II. Poorly aligned economic incentives under Regulation SHO

An additional reason for eliminating fails by making the cost of closing out the fail part of the economic cost of making a trading error is to better align economic incentives. The existing penalty for not closing a fail is prohibiting the participant from failing on a future short sale by requiring what amounts to pre-borrowing the securities before the trade is accepted.[3] This does nothing to penalize the offending party. Therefore, it provides no disincentive to creating fails in the first place. On the other hand, if the service providers know the cost of errors will be theirs to bear, there can be additional economic gains that extend from assuring that the most efficient firms survive in a competitive marketplace.

The Commission asks: "Can the close-out provision of Rule 203(b) be easily evaded?" (p. 17). The obvious answer is: any provision that has no penalty will be evaded by simply doing nothing. What can be accomplished as long as trades are not required to be settled and no federal rule is violated when trades fail? In the Commission's own words:

> "CNS is essentially an accounting system that indicates delivery and receive obligations among its members (i.e., broker-dealers and banks). These obligations *do not reflect ownership positions until such time as delivery of shares are actually made*."[4]

Therefore, money changes hands while ownership does not. Investors are being cheated of ownership rights and privileges while being denied use of the funds taken from their accounts in payment. With no real teeth, with no enforcement mechanism, and as long as neither the Commission nor the SROs will force settlement of trades, these amendments will be no more effective than the original Regulation SHO.

I'm highly confident that systems are in place to be sure that customers deliver money on time.[5] Automated systems could and should track when customer shares are not delivered on time for settlement. It does not seem reasonable that the broker could "make a notation on the order ticket at the time an order was taken which reflected the conversation with the customer as to the present location of the securities" (p. 18). Electronic trading now makes it possible for the customer to never meet or talk to a broker. While it would be a good argument against requiring documentation of the contact, this also argues in favor of not allowing fails in the first place. Trading systems should be able to detect the presence and absence of securities prior to execution. Regardless of how it is achieved, any limit on the duration of a fail is meaningless without an enforcement mechanism.

The Commission asks (p. 12) if "eliminating the grandfather provision make[s] it more difficult for short sellers to provide market discipline against abusive practices on the long side?" If short sellers cannot count on trades being completed, then the analytical model they are working with is useless.[6] This is not unlike the analytical problem described above for the counterparty in an options contract. The proper alignment of

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[3] Rule 203(b)(3)(iii).
[4] From http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm (Updated 05/06/05) Question 7.1: Do naked short sale transactions create "counterfeit shares?" Emphasis added.
[5] For more on this point, see comments submitted by Wayne Jett.
[6] For an example with a detailed explanation of how short sellers are damaged by settlement failures, see the recent lawsuit filed by Electronic Trading Group against the prime brokers.

incentives for short sellers, if the Commission desires to encourage their activity, is to assure complete and final settlement of all market activity on time. Section 23(a)(2) of the Exchange Act requires the Commission to consider "the impact any such rule or regulation would have on competition"; and in fact, grandfathered positions do damage to competition by allowing some broker-dealers and not others the advantage of additional time to effect the change of ownership required for trade settlement.

III. One share, one vote[7]: Missing from U.S. Capital Markets

I welcome the opportunity to comment on the relationship of proxy over-voting to the topic of short selling and stock lending. As I examine the issues, it becomes abundantly clear that the problem here is much more than "naked short selling." The real problem stems from a three-fold arena: shorts, loans and fails. When a stock is sold, regardless of whether the trade is marked "long" or "short," if the shares aren't presented at settlement, there are problems created in the customer's accounts when they are given what are known as "entitlements." If the failed trade (or even a legal short sale) is covered with borrowed shares, the situation is made worse when a voting or dividend record date passes because no one seems to be able to keep track of who owns what shares. I refer to the April 2005 letter from the SIA to the NYSE[8] (attached as Exhibit A) and the subsequent report of the NYSE's audit of proxy procedures[9] (attached as Exhibit B). In combination, these present a dire picture of the ability of the broker-dealer community to keep track of ownership; DTCC further enables this irresponsible behavior by inserting stock lending into settlement procedures.

The Commission notes "When Regulation SHO was proposed, commenters noted difficulties tracking individual accounts in determining fails to deliver" (p. 15). How tragic that the problem has gone this far; that not only do the broker-dealers not know whose shares are bought, sold and lent, they can't even tell if a selling customer has delivered shares. I am highly confident that they keep track of whose money has been received; there is no excuse for not extending the same level of fiduciary care and diligence to the securities side of transactions. The Commission also asks, "Should we consider requiring customer account-level close out?" Unfortunately, the Commission is not "requiring" any close outs, since even the t+13 settlement requirement is being willfully ignored as evidenced by increasing numbers of fails in threshold securities and reports from investors of delays in securities delivery that extend for months. The suggestion (further on p. 15) of a prohibition on "all short sales in [a threshold] security by an account" that has previously failed to settle could help stem the intentional creation of phantom shares, though it does little to address the underlying problems.

The Commission admits that "large and persistent fails to deliver can deprive shareholders of the benefits of ownership, such as voting and lending" (p. 8). In fact, lending can deprive shareholders of their voting rights. As is made obvious in Exhibit A,

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[7] For a comprehensive and unbiased review of this problem and its relationship to short selling and stock lending, read "Corporate Voting Charade" by Bob Drummond, April 2006, Bloomberg Markets.
[8] April 26, 2005, Securities Industry Association letter to Anand Ramtahal, New York Stock Exchange.
[9] Obtained from an anonymous source.

many investors are *unknowingly* deprived of the right to vote. I emphasize "unknowingly" because many people believe that their vote is counted just because they send the proxy instruction card back to their broker. Very few, including state and national senators I have spoken to personally, realize that the broker-dealer may be using a lottery to determine whose votes are counted.

Next, the Commission asks would "borrowing, rather than purchasing, securities to close out a position be more effective in reducing fails to deliver, or could borrowing result in prolonging fails to deliver?" (p. 17).[10] Purchasing the securities is the only effective way to close out a failure to deliver. Borrowing shares only moves the failure from one participant to another, leaving in place the problem of either duplicating voting rights or distributing them at random. The Commission itself admits that entitlements *do not reflect ownership positions until such time as delivery of shares are actually made*.[11]

In the Nanopierce Amicus[12], the Commission quotes Section 17A of the 1934 Act, in which Congress gave:

> "direction to the Commission to be followed in administering the statute. Congress found that (A) The prompt and accurate clearance and settlement of securities transactions, *including the transfer of record ownership* and the safeguarding of securities and funds related thereto, are necessary for the protection of investors and persons facilitating transactions by and acting on behalf of investors."

Yet by the Commission's own admission, transfer of record ownership *does not occur* under fails or under stock loan. Trades settled with borrowed shares, which are subject to recall, leave open a failure to receive.

The Commission makes much of the options market maker exemption and rules. While I applaud the effort to close an obvious gap in the original Rule, I question whether the Commission or some SRO has sufficient information to judge compliance with this rule. If the broker-dealers cannot keep track of which customer's shares have been lent (see Exhibit A) or reconcile long and short positions (see Exhibit B), I find it highly unlikely that the options market makers have the record keeping for compliance with this rule.

To fulfill the request for empirical data, I attach Exhibit C, which contains information collected by STP Advisory Services on proxy over-voting from the current year. Furthermore, I refer the Commission to the newsletter of the Securities Transfer Association, which regularly carries articles addressing the impact of short sales and stock lending on over-voting.[13]

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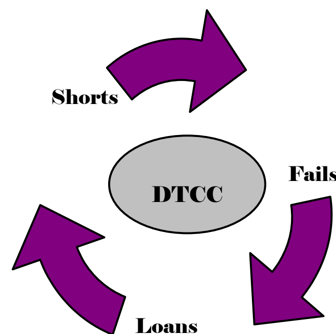
[10] DTCC has implied that borrowed shares are included in fails until the loan is paid back. In this section, I will discuss the question as asked. In Sections VI and VII, I emphasize my growing concern over the impact of DTCC's obfuscation on the ability of the Commission to effectively regulate the industry.
[11] See footnote 4 above for reference.
[12] Nanopierce Technologies, Inc., et. al. V. DTCC et. al., Nevada Supreme Court Case No. 45364, District Court Case No. CV04-01079, Brief of the Securities and Exchange Commission, Amicus Curiae, on the Issue Addressed. Emphasis added.
[13] By way of example, excerpts on the subject are included here from their December 2004 White Paper & Concept Release (Exhibit D) and Newsletter 2005 Issue 4 (Exhibit E).

The fact is that the Securities Transfer Association and the Business Roundtable have been fighting the proxy side of this battle for decades. They started at the stock exchanges, who told them that the omnibus proxy wasn't their problem, it was DTCC's program. So they went to the DTCC, who told them that they were only following the rules approved by the SEC. When they talked to staff at the SEC, as recently as 2004, they were told: "Who cares who votes the shares as long as you don't see it." The SEC's philosophy has been to intercept *over-reporting* before the issuer sees the *over-voting*. In other words, the Commission is denying there's the rhino behind the couch.

IV. Source of the problems: Shorts, Fails and Loans

If the problem were just "naked short sales," then the dilution of share value and shareholder rights would be corrected when the shorts were covered and the market price moved toward the real value of the firm. But when settlement failures are added to the picture, then the shorts have no incentive to cover.[14] The trade is allowed to remain unsettled indefinitely; there is no margin call because there is no loan. Finally, even where stock lending takes place, the problems are only compounded as explained above (Section III).

To be perfectly clear, the source of the problem is three-fold – short sales, settlement failures, and stock lending. The short sellers do harm to a company's reputation and damage to the share price, both of which limit the firm's ability to access capital, both private capital and market-based capital. Investors bear the brunt of the damage from the settlement failures because they are not getting delivery/ownership of shares after making payments. Institutional investors likely stand on both sides of the problem: as investors, they see the value of their portfolio shares eroded by the short sellers, and then they relinquish their voting rights in the pursuit of higher returns by lending their stock to short sellers. The damage caused by all three issues stems from the core problem, which is a failure on the part of management at the DTCC to provide secure, guaranteed, final settlement for trades.



[14] Therefore, there is no "de minimis amount of fails that should not be subject to a mandatory close out" (page 13).

Trades settled with borrowed shares leave open a failure to receive. The distinction between deliver and receive is probably made clearest in NSCC's Annual Financial Statements:

> "The failure of participants to deliver securities to NSCC on settlement date, and the corresponding failure of NSCC to redeliver the securities, results in open positions. ….[15] At the close of business on December 31, 2005, open positions due to NSCC approximated $3,423,028,000 ($4,346,655,000 at December 31, 2004), and open positions due by NSCC to participants approximated $2,445,326,000 ($3,328,295,000 at December 31, 2004) for unsettled positions and $977,702,000 ($1,018,360,000 at December 31, 2004) for securities borrowed through NSCC's Stock Borrow Program."

What this says is that there were $3,423,028,000 in *fails to deliver* and $2,445,326,000 in *fails to receive* for total open fails of $5,858,354,000. Including the $977,702,000 in *fails to receive* that were covered by stock borrowing, the total *level of fails* was $6,846,056,000 at December 31, 2005.

Furthermore, the Nanopierce Amicus[16] explains the purpose of a clearing agency: "to be so organized, and have the capacity, to be able to: facilitate the prompt and accurate clearance and settlement of securities transactions," and that they must be able to "enforce compliance by its participants with the rules of the clearing agency." So how is it that DTCC is unable to enforce the settlement of trades? They are explicitly given the means to do so in the Exchange Act:

> "A registered clearing agency may summarily suspend and close the accounts of a participant who …, (ii) *is in default of any delivery of funds* ***or securities*** *to the clearing agency…*"[17]

If the DTCC neglects to take action against participants who are in default of delivery of securities, and the SEC neglects to take action to discipline the DTCC, then where can investors turn for protection? [18]

The Commission asks, "Should we consider including or specifically excluding an exception for DVP trades …?" This question demonstrates a misconception that is at the core of the problems generally referred to as caused by "naked short selling." In reality, shares on deposit should be eligible for trading only if there is a way to know that they have not been previously promised for loan, pledge, etc. This is particularly true for DVP trades where no SRO is present to enforce delivery and settlement. DTCC must ensure settlement for all trades at t+3 and not allow failures beyond t+4. If a trade fails at settlement, the delivering participant should be able to fix it the next day.

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[15] The missing text is not relevant to this point. However, it describes the process by which the miscreants are able to recover any settlement monies presented to DTCC for failed trades. "Open positions are marked-to-market daily. Such marks are debited or credited to the involved participants through the settlement process." If they can drive the price of the security to zero, the DTCC will further oblige the scheme by declaring the securities "worthless," which allows them to eliminate any remaining obligations.

[16] Nanopierce Technologies, Inc., et. al. V. DTCC et. al., Nevada Supreme Court Case No. 45364, District Court Case No. CV04-01079, Brief of the Securities and Exchange Commission, Amicus Curiae, on the Issue Addressed

[17] Section 17A.a.5.(C). Emphasis added.

[18] The phrase "*protection of investors*" is mentioned 186 times in the Exchange Act of 1934.

V. States need room to take action

I applaud the efforts of Governor Huntsman in Utah plus Securities Administrator Lambiase and Attorney General Blumenthal in Connecticut. They bravely stepped into a place where property rights are not being protected by the United States to provide for some protection for shareholders, investors and companies in the States. The inherent advantages of the States are of importance in this topic. Since States have the right to register corporations, and to well regulate corporations and their securities, then the federal government can defer to the States' determination of whether and how to protect those corporations and the citizens who invest in their securities.

The following are examples of statements made by the SEC, NASD and DTCC indicating that there are no existing rules at the Federal level to protect investors from settlement failures:

- "failure to deliver securities on T+3 does not violate the rule." Footnote 2 of the file.
- "Should a member … fail to deliver the security on settlement date, the NASD deems such conduct inconsistent with the terms of [the] Rule …" NASD Rule 3370(b)(4)(C). Therefore, fails are not a violation of a rule and there are no consequences for failing.
- "NSCC is not a regulator, nor does it exercise enforcement powers." Larry Thompson, DTCC General Counsel, Euromoney Letters to the Editor, June 2005.

Since neither the SEC nor any SRO can force the settlement of a trade, then it must be left to the States to protect investors who want delivery of securities they have purchased.[19] In fact, it would appear from the above that the States are the *only* place that investors can get protection in these matters. If there is a trade-off between the protection of corporations and investors and economic integration, it is one that the State governments can develop more effectively than if there were one Federal rule. The States have the ability to work out therapeutic approaches to an issue that continues to elude Federal regulators.

Surely, since there apparently is no rule in place at the Federal level to enforce the delivery of ownership of securities to the purchaser, then the SEC should not stand in the way of the States when they try to enforce delivery of a product for which an investor has paid. Further, corporate issuers should not be intimidated into believing that they are violating "short squeeze" prohibitions when they try to help investors get the product for which they have paid.

It is well understood in development economics that autocrats face incentives to provide selective benefits and, as such, they may attempt to maximize control over economic activity. In order to motivate investors to depend on government officials to place and protect investments, autocrats may overlook or even encourage opacity, corruption or inadequate protection at the federal level. Commercial transaction costs for private citizens will be better reduced when democratic leaders face incentives to provide such

[19] I respectfully request that the SEC no longer submit amicus briefs in which the SEC supports the defense that these are matters outside the jurisdiction of the States in lawsuits brought by shareholders and issuers in the States against the DTCC and other parties in matters relevant to settlement failures.

protection broadly. The incentives for correct behavior in these cases are clearly with the States.

VI. Call for Transparency @ DTCC

The Commission specifically asks commenters to “provide analysis and data to support their views.” This is exceedingly difficult to do since DTCC is obfuscating the real magnitude of the problem by using poor metrics and biased statistics. For example, in footnote 3 (p. 3) of the file there are NSCC statistics on average daily failures to settle as a percentage of dollar value. It is deceptive to use a figure based on dollar value to support the statement that “the majority of trades settle on time” because a statistic describing the majority of “trades” should be by number, not by value.

Again, in footnote 18 (p. 8), the Commission offers NSCC statistics from two unequal time periods to support the statement “that Regulation SHO appears to be significantly reducing fails to deliver.” Data for the *9 months* from April 1, 2004 to December 31, 2004 are compared to the *17 months* from January 1, 2005 to May 31, 2006. Comparing statistics from periods of *different lengths* is bad math, at best. Furthermore, it is well known that market data exhibit seasonal variation.[20] It is particularly deceptive to include January in one and not the other, since the “January effect” is especially well-known and studied.

Footnote 18 continues giving a list of statistics from NSCC that are presented with inconsistent measurement units. In most cases, NSCC does not reveal if percentages are by value, by transaction or by number of shares. At best, this is a sloppy presentation of statistical data. At worst, it is an attempt to deceive.

The statement in footnote 19 (p. 8) is blatantly biased. It offers the number of Threshold securities as a percentage of equity securities “including those that are not covered by Regulation SHO.” Including equity securities not covered by Regulation SHO in the denominator of a statistic meant to depict the scope of the problem identified with Regulation SHO only serves to obfuscate. These biased statistics serve to deceptively minimize the problem and exaggerate the progress made by Regulation SHO.

Unfortunately, DTCC’s obfuscation may be damaging the Regulation SHO Threshold lists themselves. In the Final Rulemaking on Regulation SHO, the terms “fails” and “fails to deliver” are used interchangeably, without reference to “fails to receive.”[21] For

[20] For example, see Porter, R. Burt, "Measuring Market Liquidity" (October 2003), which provides evidence of a strong January seasonal effect on liquidity, and which summarizes recent research suggesting that aggregate market liquidity varies over time. Available at SSRN: http://ssrn.com/abstract=439122. See also Kamstra, Mark J., Kramer, Lisa A. and Levi, Maurice D., "Winter Blues: A SAD Stock Market Cycle" (October 2003), which demonstrates seasonal differences in market behavior using international data. Available at SSRN: http://ssrn.com/abstract=208622. For additional evidence, see DeGennaro, Ramon P., Kamstra, Mark J. and Kramer, Lisa A., "Seasonal Variation in Bid-Ask Spreads" (March 2006). Available at SSRN: http://ssrn.com/abstract=624901.

[21] The following terms do not appear anywhere in the final rulemaking: “fail to receive”, “fails to receive” or “failure to receive” or “failures to receive”. The word “receive” appears 36 times, primarily in the context of where the SEC has “received” comments.

example, in the Final Rule a threshold security is described as one where "there are aggregate *fails to deliver* at a registered clearing agency of 10,000 shares or more per security; that the *level of fails* is equal to at least one-half of one percent of the issuer's total shares outstanding;…" (emphasis added); and in the accompanying footnote, "For example, if an issuer had 1,000,000 shares outstanding, one-half of one percent (.005) would be 5,000 shares. An aggregate *fail to deliver* position at a clearing agency of 10,000 shares or more would thus exceed the specified *level of fails*."[22]

Compare that to the language used by DTCC's Larry Thompson when he refers to "…about $1.1 billion of the 'fails to receive,' or about 20% of the total fail obligation." These figures belie his revelation that "…fails to deliver and receive amount to about $6 billion daily,…"[23]

One is left to wonder if the DTCC is taking literally the SEC's instructions that "[a]t the conclusion of each settlement day, NSCC will provide the SROs with data on securities that have aggregate *fails to deliver* at NSCC of 10,000 shares or more." Does DTCC report both the *level of fails* and the number of *fails to deliver*? The SEC's instructions to the SROs are: "For the securities for which it is the primary market, each SRO will use this data to calculate whether the *level of fails* is equal to at least 0.5% of the issuer's total shares outstanding of the security." Taken as written, using DTCC's distinction between fails to deliver and fails to receive, the SROs should be doubling the reported number of shares failed in order to arrive at the level of fails used to calculate the 0.5% threshold.

If one needs additional examples of DTCC's obfuscation, I offer the following:

- In a June 2005 Letter to Euromoney, Larry Thompson says that "a small minority of delivery failures (0.25%) are filled by shares borrowed through the SBP" [Stock Borrow Program]. In an earlier interview he said that "about 20% of the total fail obligation" was solved through SBP. If believed, this would mean that 20% of the value of fails is found in 0.25% of the shares? Yet the DTCC and the SEC want us to believe that the problem exists primarily for small and mid-sized companies.[24] Of course, no reasonable person could believe all three things at the same time.
- In the @dtcc interview, Thompson describes "fails to deliver" as a number of transactions and "fails to deliver and receive" as a dollar amount,[25] thereby making comparison and statistical analysis impossible.

- DTCC presents the value of fails as a percentage of *all* transactions processed. But there are numbers presented in various annual reports which indicate that netting eliminates the need for settlement in over 90% of transactions

[22] Page 48016, in Part V. Rule 203. B. 1.
[23] $1.1 billion is only 18% of $6 billion. Naked Short Selling and the Stock Borrow Program, @dtcc interview with Larry Thompson, March 24, 2005. Available at http://www.dtcc.com/Publications/dtcc/index.htm
[24] See, for example, statements at http://www.sec.gov/spotlight/keyregshoissues.htm
[25] "Currently, fails to deliver are running about 24,000 transactions daily"; "fails to deliver and receive amount to about $6 billion daily."

processed.[26] Therefore, the fail rate could be significantly higher than they claim. Furthermore, there is a distinction between value and volume where trades are concerned. The difference can be as high as 5 percentage points between the two.[27]

- DTCC makes clear in their statistics that borrowed shares are included in fails until the loan is paid back. A failure to receive is closed out with borrowed shares but a failure to deliver is retained by the DTC (who has an open debit on their books awaiting the return of the loaned shares from NSCC). This distinction is made explicit by Thompson in the 2005 interview @dtcc: "The Stock Borrow program is able to resolve about $1.1 billion of the 'fails to receive,' or about 20% of the total fail obligation." The Commission asks, "Would borrowing, rather than purchasing, securities to close out a position be more effective in reducing fails to deliver, or could borrowing result in prolonging fails to deliver?" (p. 17). Obviously, borrowing will not eliminate a failure to deliver.

So what is the reality? According to an article by Bob Drummond in Bloomberg Markets (September 2006) "On an average day in March, [those] unsettled trades amounted to more than 750 million shares in almost 2,700 stocks, exchange-traded funds and other securities…."[28] Further, the article reports: "At the end of 2005, about 23,000 trades hadn't settled …." If these numbers are right, then the average failed trade was for about *32,600* shares, compared to the *300* shares or less DTCC says comprise 70% of all transactions.[29] This is my final and most recent example of the kind of information that DTCC is hiding by releasing vague and misleading statistics.

VII. Call for Transparency @ SEC

Unfortunately, obfuscation has not been limited to DTCC. Statements by the Commission also raise questions. In footnote 2 (p. 11) of the file: "Between the effective date of Regulation SHO and March 31, 2006, 99.2% of the fails that existed on Regulation SHO's January 3, 2005 effective date have been closed out. This calculation is based on data, as reported by NSCC, that covers all stocks with aggregate fails to deliver of 10,000 shares or more." If only 0.8% of grandfathered fails are still open, then why does anyone think eliminating this small piece will make a difference? How big are these 0.8% of grandfathered fails that eliminating them will serve to achieve the intended objective of these amendments ("to reduce the number of persistent fails to deliver attributable primarily to the grandfather provision …")?

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[26] For example, from the 1998 NSCC annual report, "Total value of transactions processed was $44.6 trillion." and "Netting eliminated the need to settle $42.6 trillion in trading activity." Therefore, only $2 trillion actually went to settlement.

[27] For example, from 1998 NSCC annual report: "And on a peak day, November 16, of $2.8 trillion entering the system for netting and settlement, GSCC reduced the obligations of participants by 94 percent for all transactions and 89 percent of the dollars." Similar numbers are not released for NSCC's equity activity, which would clear up a lot of questions.

[28] According to Depository Trust & Clearing data obtained by Drummond from the SEC through Freedom of Information Act requests.

[29] "…[A]pproximately 70% of equity trades currently [2006] submitted to NSCC are for 300 shares or less." DTCC Important Notice A# 6218, P&S# 5788, March 15, 2006.

In the request for comments, the Commission puts forth "the premise that a high level of fails to deliver for a particular stock might harm the market for that security." And then asks, "In what ways do persistent grandfathered fails to deliver harm market quality for those securities, or otherwise have adverse consequences for investors?" Without the routine release of the number of fails per company, how can anyone support comments on this matter with data? The primary party with an interest in researching this is the company itself. At a minimum, the numbers (of transactions, shares and value) should be released to the issuer for analysis. To require FOIA requests from every issuer is simply obstructionist.

I am one who seeks greater transparency, including requiring "the amount or level of fails to deliver in threshold securities to be publicly disclosed." Information about settlement failures would put investors on notice that they need to follow up on the delivery of paid-for shares from their brokers. Ideally, much as was intended by the Utah law passed this year, the disclosure should be made by each broker of the aggregate fails to deliver (trades, shares and value) for each security. Having the broker make the disclosure would further protect shareholders as they would be aware if there is a particular problem with their broker.

Providing the investing public with access to information about settlement failures by individual brokerage firms and on individual stocks would *not* increase the potential for manipulative short squeezes. As I said earlier, a short squeeze would occur if investors were driven to purchase the stock in the first place, not if they are driven to demand delivery of that for which they have already paid.

VIII. Clarifications and Corrections

- A grammatical correction is required in the following text on page 49:
  (ii) The provisions of this paragraph (b)(3) shall not apply to the amount of the fail to deliver position in the threshold security that is attributed to short sales by a registered options market maker, if and to the extent that the short sales are effected by the registered options market maker to establish or maintain a hedge on an options position that ~~were~~ [was] created before the security became a threshold security;

- The definition of settlement found in footnote 2 is misleading. It represents settlement as a one-sided process where the delivery of payment is divorced from the receipt of the securities that the investor has purchased. In fact, this is core to the problem in the capital markets today: investors are paying for securities, and then not getting delivery.

- The file describes CNS in footnote 11 as a system which "nets the securities delivery and payment obligations of all of its [NSCC's] members." This should read "nets the securities delivery obligations for each of its members in each security and nets the payment obligations for each of its members." To state this otherwise is a profoundly misleading statement, one that leads to confusion among the commenters. Some have

taken this wording to mean that there is one net position in each security at the end of the day.

- It is unfortunate that the Commission is using “short squeeze” in footnote 16 in the context of requiring brokers to deliver to investors that which they have purchased. The phrase “illegal short squeeze” should be reserved for intentional acts of manipulation that drive investors to buy the stock in the first place, not actions taken AFTER the purchase in an attempt to gain delivery of bought and paid for shares.

Closing

In closing, I hope the Commission will let go of the romantic illusion that correctly marking trades is an alternative to a strong and proficient settlement system. Capital market efficiency can only be enjoyed after enduring the cost of repairing the formal system.

Thank you for your consideration of my comments. Please feel free to contact me at 310 285 8153 if I may be of assistance.

Sincerely,

Susanne Trimbath, Ph.D.
CEO and Chief Economist

Exhibits:

A. SIA Letter to NYSE
B. NYSE Audit Report
C. Proxy Problem Summary
D. STA White Paper (excerpt)
E. STA Newsletter (excerpt)