Nancy M. Morris, Secretary September 27, 2006
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-0609

RE : Amendments to REG SHO Release No.: 34-54154, File No.: S7-12-06

Dear Secretary,

Thank you for the opportunity to comment on Reg SHO and the proposed amendments to that rule.

I would like to point out that the problem of delivery failures is one of de-linkage between clearance and settlement. If delivery was required in order for participants to be paid, there would be few or no delivery failures. That simple logic is the underpinning of Congress's instructions in Section 17A, indicating that a linked or coordinated clearing and settlement system was necessary for investor protection. Being that the SEC in its wisdom elected to de-link the two, and allow a "for-profit" entity owned by the participants and exchanges (the DTCC) to have the monopoly in clearing and settlement, it is no wonder that entity would push for rules that accelerate clearing (payment), and relegate delivery to afterthought status. That the SEC has allowed this investor-protection-adverse state of affairs to be the prevailing methodology is baffling. It is this de-linkage that causes delivery failures to be possible, if not pervasive.

The current regulatory structure is one where investors pay for securities, yet no delivery is necessarily forthcoming. This compromises the integrity of the markets. By allowing participants to refuse to deliver that which they sold and have been paid for, the SEC is condoning institutionalized fraud against investors. This practice also facilitates manipulative efforts to depress share prices, as virtually unlimited supply can be generated by unscrupulous participants, overwhelming any buying interest. We have seen this in many of the longtime residents of the Reg SHO Threshold list.

Section 17A of the Securities Exchange Act of 1934 states that, *"The prompt and accurate clearance and settlement of securities transactions, including the transfer of record ownership...are necessary for the protection of investors…"* and Section 36 states clearly that exemptions are only allowed, *"…to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors…"*. So per Congress, prompt delivery (settlement) is required, and the only exemptions allowed are those required to protect investors. That is not how the SEC regulates, and that must change to be consistent with the 1934 Act that created the SEC.

The NCANS letter dated September 18, 2006 describes in detail the deficiencies of the current regulatory scheme as it relates to exemptions for certain classes of participants from reasonable delivery rules. It also addresses the systemic risks arising from the ongoing unregulated creation of securities entitlements, the harm caused to investors from the lack of adherence to the Congressional mandate that clearance and settlement be linked, the continued damage to market integrity resulting from a lack of any transparency for short interest and delivery failures, the absence of any disincentive for failing to deliver due to a lack of any meaningful penalties for violation of prompt delivery requirements, and the macro damage to the reputation of the US system caused by a general refusal by the SEC to uphold Section 17A's requirement for prompt clearance and settlement of all trades, including transfer of record ownership.

The SEC has provided exemptions from reasonable delivery rules to market makers and options market makers, in order for those participants to have unimpeded liquidity. This is a subsidy for that class of participants, wherein the market maker's cost to hedge their sale of put options is transferred from those speculating in options, and instead imposed upon unsuspecting equity investors who derive no benefit from the subsidy. This is the antithesis of investor protection, and sacrifices the integrity of the equities market for liquidity in the derivatives market – something the SEC is not empowered to do. From the September 25, 2006 Wolverine letter to the SEC:

"Presently, Wolverine is able to hedge options trades by selling shares short without first locating stock and generally is not subject to the mandatory close-out requirements for threshold securities. These exceptions allow Wolverine to continuously disseminate bids and offers (i.e., be on both sides of the market) because it can easily hedge market maker option trades with stocks that are illiquid and/or considered "hard to borrow."

Again, the exemption allows the options market maker more profitable trading and zero cost liquidity – and equity investors pay for it, with uncontrolled dilution and delivery failures, resulting in lower share prices. There is no legitimate reason for this exemption other than to support options trading at the expense of equities investors.

Also alarming is that the SEC has engaged in a campaign of apparent deception, wherein it obfuscates the true extent of the naked shorting/failure to deliver problem by using misleading or incomplete data. The NYSE FTD data captured in the FOIA section of TheSanityCheck.com shows conclusively that the "improvement" touted by the SEC from Reg SHO is a sham, at least on that exchange – 65 million FTDs were reported on the first day Reg SHO went into effect, and 17 months later, on the last reported day, 65 million FTDs were reported, with an increase in the total number of companies with 10K or more FTDs. This is not an improvement by any metric. The aforementioned Wolverine letter, as well as other participant-drafted correspondence, cite the SEC's statements that Reg SHO has resulted in measurable improvements as their foundation for advising the SEC to maintain the status quo. The NYSE FTD data exposes that justification as fallacious.

This sort of dishonesty from a regulator chartered with protecting investors is inexplicable, and must end.

A warning shot across the industry's bow is the steep drop-off in companies wishing to participate in the US system. Of note is that the NY Mayor Bloomberg just commissioned a $600,000 study to explore why the US is losing IPO business. Perhaps the explanation can be found by examining the aforementioned FOIA FTD data, and speculating as to why any company would want to immerse itself in a system with so many inequities and loopholes, and which is so easily gamed by larcenous participants. The loss of investor and issuer confidence in the US equity markets carries an inevitable long-term cost, not the least of which is the loss of business to exchanges, as companies seek better-regulated forums for their equity offerings. We are currently seeing that fallout.

Investors in the US markets deserve accurate and timely reporting of material information, including short interest, and failure to delivers, in the companies they invest in. Monthly short interest reporting, two weeks out of date, is inadequate. Zero reporting of delivery failures is inadequate. Disingenuous spin from our regulator is inadequate. The markets must have transparency so that investors are not dependant upon a regulator's assurances that all is well, when FOIA data conclusively demonstrates those assurances are false and misleading.

Therefore, I would advise the SEC to set clear, achievable milestones for addressing the delivery failure issue:

1) Put an end to grandfathering delivery failures. Immediate revocation of the grandfather exemption, with no further grace periods.
2) Transparency. Implement daily reporting of short interest and delivery failures.
3) Terminate exemptions for some classes of participants. Put an end to delivery exemptions for market makers and options market makers, as they are not in the public interest and are antipodal to investor protection.
4) Regulate security entitlements, requiring prompt delivery of all underlying securities, on a one-for-one basis, for each entitlement issued.
5) Require that each share have its own serial number for verification of delivery.
6) Require a borrow before short selling for all participants. Implement a requirement that all securities have deliverable shares prior to affecting a sale. Short sales must have a borrow, not merely a "locate."
7) Impose penalties for violation of the rules. Initiate implementation and enforcement of meaningful penalties for violations, including revocation of licensure for recidivist violators.
8) Require buy-ins to cure delivery failures past a reasonable timeframe. Mandatory buy-ins for transactions failing delivery beyond T+5.

These simple milestones would correct 90+% of the deficiencies in the current regulatory scheme, and would go a long way to restoring investor confidence in the integrity of the markets. Until they are implemented, no investor or issuer is safe, and the SEC's regulation and success in protecting investors is illusory, selective, and inadequate.

The SEC must fulfill its role to police Wall Street and protect investors. Settle the trades, every time. Punish those who refuse to do so. Without exception. Buy-in transactions that have failed delivery. Report accurately and in a timely manner. Require a pre-borrow. Comply with the 1934 Act in its entirety.

The solution to this problem is simple in its essence. Proposals are laid out in the NCANS letter. My additional comments are intended to underscore that the feedback from the industry we've seen after the NCANS letter was submitted amounts to demands for special treatment at the expense of investor protection, all predicated on the false notion that Reg SHO in its current form has had any measurable positive impact on delivery failures. We now know that to be false with respect to the NYSE data, and by extrapolation, likely with respect to the other exchanges as well.

Reg SHO has not done its job. Not even close. Continuing with a flawed rule, which lacks basic penalties for violation, and hosts a plethora of exemptions, is a recipe for disaster.

End the grandfathering. Rein in the options market makers. Settle the trades. Restore the integrity of the market system. This is the SEC's opportunity to atone for the shortfalls in the current rule, and to implement a set of real, effective solutions. I am optimistic that it will act responsibly and do so.

Respectfully,

Bob O'Brien
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