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August 29, 2006

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

[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]

[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.

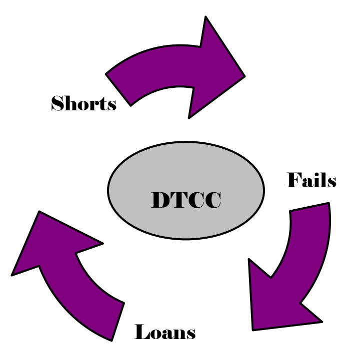
[13] By way of example, excerpts on the subject are included here from their December 2004 White Paper & Concept Release (Exhibit D) and Newsletter 2005 Issue 4 (Exhibit E).

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)

Securities Industry Association
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April 26, 2005

Mr. Anand Ramtahal
Vice President
Member Firm Regulation
New York Stock Exchange
11 Wall Street
New York, NY 10005

Dear Mr. Ramtahal:

The members of the SIA[1] Ad-Hoc Committee on Proxy Over Reporting (the "Committee") wish to express their gratitude for the NYSE's participation in the highly productive and interactive meeting held on March 4, 2005 at SIA's New York office. Since the NYSE and the SEC have been looking into the process of over reporting, we thought it would be beneficial to convene a meeting to discuss the methodologies used by firms to accommodate the proxy process. As stated at the onset of the meeting, our goal was to review the generic proxy flows, reach consensus on the different processes, and create industry best practices that are approved by the NYSE. Our members are seeking greater clarity regarding best practices in order to ensure compliance with NYSE and SEC regulations.

Over Reporting

SIA, together with its Corporate Actions and Securities Operations Divisions[2], have been reviewing the proxy over reporting issue since mid-2004. This issue was raised by tabulators and several transfer agents. Certain SIA member firms also alerted us that it had become a focus of recent NYSE examinations.

Over reporting occurs when ADP or a financial institution submits to an issuer's tabulator a voting position on behalf of a broker-dealer (or bank) that exceeds the record

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[1] The Securities Industry Association brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. At its core: Commitment to Clarity, a commitment to openness and understanding as the guiding principles for all interactions between investors and the firms that serve them. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated $227.5 billion in domestic revenue and $305 billion in global revenues.

[2] SIA Divisions are composed of individuals engaged in specialized areas of activity who work together in addressing issues and problems in their spheres of expertise and educate their constituents via seminars and conferences throughout the year. The Divisions maintain close liaison with other elements of SIA and are autonomous in their operations.

date position for that broker-dealer as determined by DTC and securities registered in that broker or bank's nominee name. The potential for over reporting may exist for a number of reasons associated with improper position reconciliation, such as: margin account securities on loan; fails to receive; and, shares registered in the broker's own name.

One of the conclusions SIA reached from our research was that broker-dealers should provide the tabulators with a street name vote that reconciles with the voteable record date position. In this regard, we believe that ADP offers a critical tool for achieving this goal - the ADP Over Reporting Prevention Service that works in conjunction with DTC and broker-dealers to avoid over reporting. In September 2004, I wrote to ADP proxy service subscribers strongly encouraging them to use this service.

It is relatively simple for broker-dealers to subscribe to ADP's Over Reporting Prevention Service. Firms need only to send a letter to the DTC Proxy Department, with a copy to their ADP Client Service Representative, requesting them to release their firm's stock record date position to ADP on its nightly transmission. The service compares a participant's reported position to its DTC position, flags any differences, and enables the participant to make appropriate adjustments. To date, more than 100 brokers have subscribed to this service, representing 90%[3] of the street positions. As NYSE requested, ADP and SIA representatives are actively working on contacting the other firms that account for the remaining 10% of street positions to urge them to use the service.

March 4, 2005 Meeting Recap

At our March meeting, the Committee noted its support of the industry's use of the ADP Over Reporting Prevention Service, particularly as it offers a reconciliation process to counter the potential for over reporting. In recent studies performed by ADP, they were unable to find any existence of an over vote when using this service.

Regarding margin accounts, which are allowed to vote their entire position even if their shares have been hypothecated[4] pre or post reconciliation (see Appendices A and B), it is our understanding from the discussions at the March meeting that no rule exists to give us guidance in this area. Therefore, firms have been relying on their margin agreements, which allow a firm to reduce customer votes based on that firm's determination that the shares have been hypothecated.

The Committee agrees with the NYSE's recommendation made at the March meeting to include additional disclosure language in each proxy mailing, reminding customers that their beneficial voting rights may be reduced by shares that are hypothecated.

[3] Source: ADP

[4]Hypothecation of Securities**:** pledging of securities to brokers as collateral for loans made to purchase securities or to cover short sales, called margin loans. When the same collateral is pledged by the broker to a bank to collateralize a broker's loan, the process is called rehypothecation.

We also understand from discussions at our meeting, that NYSE Market Regulation and Enforcement has concluded that as long as a firm performs a reconciliation - be it pre or post mailing - and there is no over voting, then the firm's process does not conflict with any NYSE rules. The Committee supports firms having the option of performing either a pre or a post reconciliation, and believes that such flexibility should be retained. This position is supported by the results of the Committee's review of pre and post workflows.

As we also mentioned in March, the Committee believes that it is important that firms exercise some form of "in-house" due diligence in reconciling client positions for the purpose of evaluating the voteable shares, instead of relying completely on a third party vendor. The Committee also believes that whatever methods are used to reconcile client positions (such as an impartial lottery or proration, as explained in Appendices C2 and C3), they should be proportional and equitable among all clients.

As part of its review of the proxy process, the Committee compared it with the dividend payment-in-lieu process (see Appendix C). The Committee found that there are significant differences between the processes, which include:

- All beneficial owners, regardless of their margin status, are entitled to receive& dividend payments, but they may not be entitled to vote their shares.&
- There are differences between making investors whole with cash on a payable date, and making investors whole with voting rights on record date.
- The dividend process adopted is a result of regulation. Proxy regulation does not require a specific allocation process.
- While aspects of the logic used in dividend processing may be applicable to some of the allocation methods used in proxy processing, there are other allocation methods that are in place that meet the requirements.

A Comparison of the Pre and Post Mailing Reconciliation Processes

In our March meeting, you requested that we prepare a summary of the pros and cons of both the pre and post mailing reconciliation processes. We offer such a summary below, and both scenarios assume the firm is using the ADP Over Reporting Prevention Service. The NYSE rules governing proxies require broker-dealers to perform due diligence by reconciling their positions but, as mentioned earlier, do not express a preference for either the pre or the post mailing reconciliation process.

A. Pros Common to both the Pre and Post Mailing Reconciliation Processes

- The balancing of the stock record to offset shorts, loans and fails is in keeping with street practice – the right to vote is decided by who possesses and controls the security.
- The broker-dealer's risk of over voting is minimized.
- The allocation process is equitable and proportional since an impartial lottery, proration, etc. are used to reduce shares of margin accounts when needed.

- ADP receives the DTC position and provides its clients with the comparison for review.
- Regardless of the method used, adjustments can still be made due to potential over voting.

B. Additional Pros re: the Pre -Mailing Reconciliation Process

- Since shares are reduced systemically based on need, very little intervention is required by the proxy department.
- Share reduction is accomplished in a proportional and equitable manner utilizing standard acceptable street processes such as an impartial lottery or proration.
- Client disclosure of the adjusted share quantity is documented on the voting card.

C. Additional Pros re: the Post -Mailing Reconciliation Process

- Clients are allowed to vote their entire position and no reduction to any client's position takes place unless there is a potential over vote situation.
- There will be minimum client impact in the proxy process.
- Potential over vote situations are reported to the broker-dealer by ADP's Over Reporting Prevention Service and share reductions are made only when required.

D. Cons re: the Pre -Mailing Reconciliation Process

- Since shares are reduced from clients' positions before the vote is cast and, since on average only 35% of clients usually vote, clients whose positions have been reduced may not vote their full position.
- This process requires internal programming work to account for impartial lottery or proration, etc. allocation methods.
- If an entire position is reduced (i.e., due to a fail to receive or the shares being hypothecated), a client may be excluded from receiving a proxy mailing that includes information about their investments.

E. Cons re: the Post -Mailing Reconciliation Process

- The number of votes cast may not be consistent with what the client has received on the proxy card.
- Timing of votes and concentration of meetings may provide the proxy department with a very short window of time to reconcile an over vote situation.
- If a proportional and equitable proration is performed, a large number of client positions may be reduced.

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Record Retention

The NYSE record retention rules in this area[5] were adopted when broker-dealers performed the entire proxy process themselves, including receiving and mailing proxies, tabulating votes, issuing a nominee's final vote on an omnibus proxy, and billing for the

[5] See Appendix D.

mailing. Firms maintained detailed records on the solicitation, issuer requirements, receiving and mailing proxies, NYSE opinions on the nature of the proposals, signed proxy cards, tabulating tapes, master ballots, and invoices (supported by the expenses incurred).

Over the past several years, an increasing number of broker-dealers have outsourced the proxy process to ADP Investor Communications. At this time, we believe a majority of firms are doing so. By contracting with ADP for such services, broker-dealers have access to ADP's ProxyPlus system and can monitor ADP's processing of its proxies. In addition, ADP is required by contract with the firm to maintain the applicable records up to and in some cases exceeding seven years (NYSE Rule 452.20 requires three years), including - in our view - samples of the proxy material mailed to the beneficial clients. We believe that ADP maintains adequate records to support their process. Deloitte & Touche performs independent annual audits to verify this is the case, and presents certifications to each broker-dealer that are maintained by the firms as a record of compliance.

The Committee believes that the record retention requirements for the broker-dealer should reflect the work performed by the proxy department in today's enviornment, i.e. client proxy support, monitoring of ADP's proxy function, and the international proxies. It is the Committee's understanding that, in accordance with NYSE rules, the housing of a broker-dealer's proxy processing and voting records at ADP adheres to the requirements of accessibility within a reasonable timeframe for retrieval.

In conclusion, the Committee wishes to express its appreciation for your time and interest in this important project. Our understanding is that we have been able to reach agreement with the NYSE on the use of either pre or post reconciliations as a tool for reconciling proxy voting, as well as on the additional disclosure language for proxy mailings. We welcome the opportunity to meet with you in the near future to discuss the contents of this letter and to bring closure to any open issues. Our ultimate goal is to produce an industry wide SIA document on Proxy Best Practices that is supported by the NYSE and facilitates the proxy process for the benefit of investors and all industry participants.

Yours truly,

Donald D. Kittell
Executive Vice President

cc: Tony Alberti, NYSE
Michael Alexander, Charles Schwab
Larry Bergmann, SEC
Richard Bommer, SIA
Jerry Carpenter, SEC
Bernadette Chichetti, NYSE
John Colangelo, DTCC
Arthur Cutter, UBS
Richard Daly, ADP
Don Donahue, DTCC
Diana Downward, DTCC
James Duffy, NYSE
Richard Ketchum, NYSE
Catherine Kinney, NYSE
Phil Lanz, Bear Stearns
Patricia Mobley, DTCC
Ronnie O'Neill, Merrill Lynch
John Panchery, SIA
Simon Swidler, NYSE
Lew Trezza, FMR
Steve Walsh, NYSE

Appendix A, (Example Only - Does not represent all B/D processes)

ADP OVERVOTE CLIENT

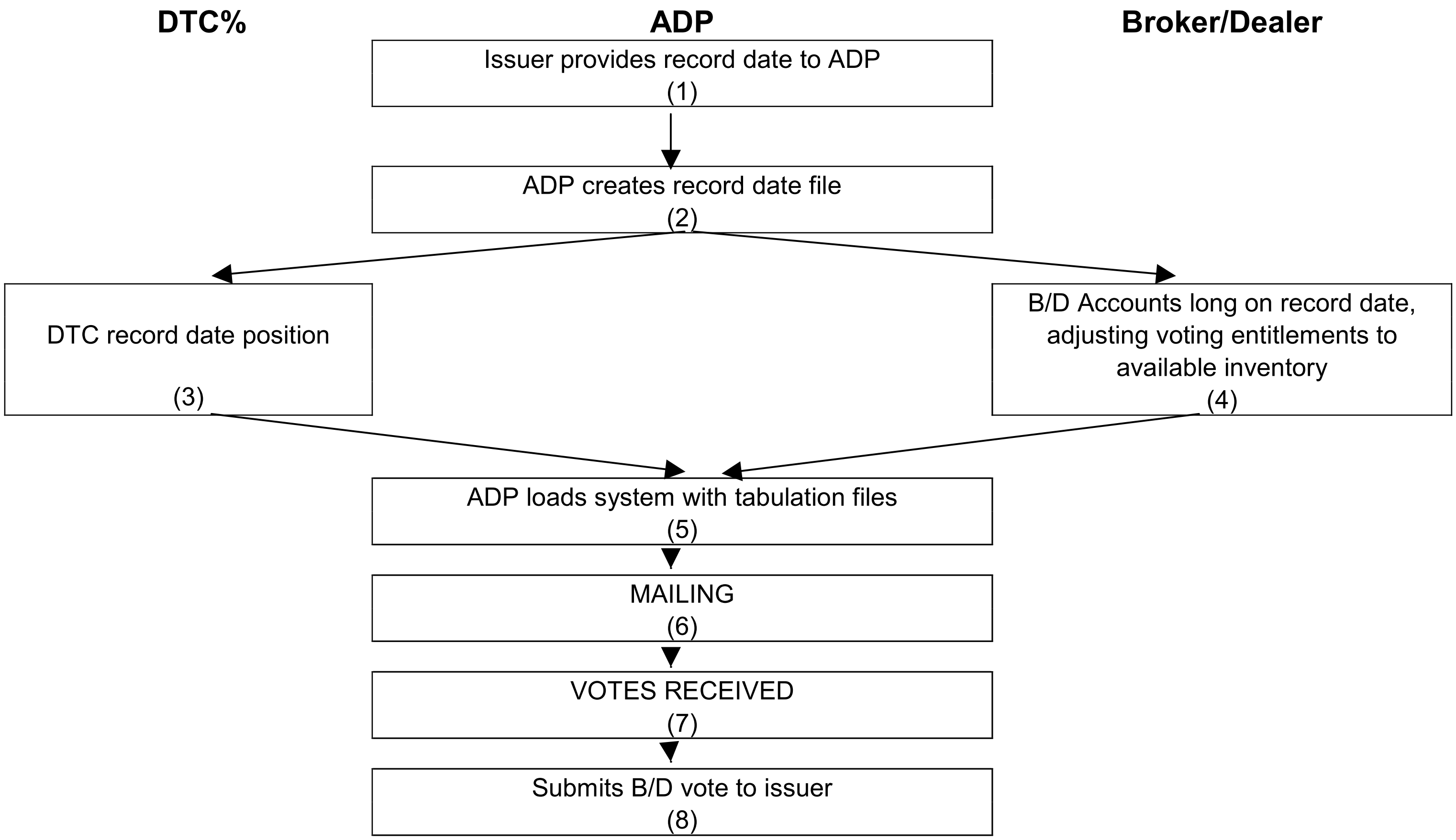
Post-Mailing Reconciliation

(All meetings, routine and non-routine)

NOTES:

(1)	Issuer contacts ADP requesting material quantities. Search request contains other information, including record date
(2)	ADP transmits file to B/D and DTC containing CUSIPs of interest for current record date
(3)	DTC transmits participant listings with record date securities positions for which DTC has received authorization from its participants (B/D signs letter of authorization for DTC to release this information to ADP as a part of Overvote Service enrollment process)
(4)	B/D systems adjust stock record to eliminate non-voteable shares, such as Delivery versus Payment accounts, shares held in customer name, intercompany offset accounts, triparty accounts and proprietary long and short positions. Margin accounts receive full voting on long shares. Reported shares may exceed DTC and registered inventory
(5)	ADP loads both files to tabulation system.
(6)	ADP mails proxy materials to clients. Margin account Voting Instruction Form reflects full long position.
(7)	Clients return voting instructions to ADP via hard copy, telephone, internet, or Proxy Edge (ADP Institutional Voting System)
(8)	If voting returns exceed DTC position, B/D is notified via e-mail, PostEdge (ADP Web Portal) or hard copy report
(9)	B/D examines stock record, to identify additional voteable shares (i.e. registered positions), if any, and to segregate cash clients, fully paid margin clients, and non-fully paid margin clients
(10)	Vote tabulation is adjusted manually so that cash and fully paid margin clients receive maximum voting
(11)	After satisfying cash and fully paid margin clients voting instructions, non-fully paid margin client voting instructions are tabulated. These instructions are prorated to inventory available after step (10)
(12)	The voting results in steps (10) and (11) above are combined and transmitted to ADP
(13)	ADP submits manual voting result calculated in (12) above to issuer
	B/D uses various reconciliation methods to ensure the accuracy of ADP's process

ADP OVERVOTE CLIENT
Pre-Mailing Reconciliation
(All meetings, routine and non-routine)



NOTES:

(1)	Issuer contacts ADP requesting material quantities. Search request contains other information, including record date
(2)	ADP transmits file to B/D and DTC containing CUSIPs of interest for current record date
(3)	DTC transmits participant listings with record date securities positions for which DTC has received authorization from its participants (B/D signs letter of authorization for DTC to release this information to ADP as a part of Overvote Service enrollment process)
(4)	B/D systems adjust stock record to eliminate non-voteable shares, such as Delivery versus Payment accounts, shares held in customer name, intercompany offset accounts, triparty accounts and proprietary long and short positions. Margin accounts are adjusted systematically using a lottery or proration scheme as necessary to ensure total reported shares do not exceed DTC and registered inventory.
(5)	ADP loads both files to tabulation system.
(6)	ADP mails proxy materials to clients. Margin account Voting Instruction Form reflects adjusted long position.
(7)	Clients return voting instructions to ADP via hard copy, telephone, internet, or Proxy Edge (ADP Institutional Voting System) Note: Although B/D is a participant in the Overvote Service, an overvote should be unlikely due to pre-reconciliation in step (4). If an overvote should occur, the process would continue as in step (9) of the Post-Mailing Reconciliation model
(8)	Voting results are conveyed to issuer

B/D uses various reconciliation methods to ensure the accuracy of ADP's process

Appendix C, Example of the Lottery Process for Dividend Payments in Lieu*

§1.6045-2(f)(2) *Payments in lieu of dividends other than exempt-interest dividends*--(I) *Requirements and methods.* A broker that receives substitute payments in lieu of dividends other than exempt-interest dividends on behalf of a customer and is required to furnish a statement under paragraph (a) of this section must make a determination of the identity of the customer whose stock was transferred and on whose behalf such broker receives substitute payments. Such determination must be made as of the record date with respect to the dividend distribution, and must be made in a consistent manner by the broker in accordance with any of the following methods:

(A) Specific identification of the record owner of the transferred stock;

(B) The method of allocation and selection specified in paragraph (f)(2)(ii) of this section; or

(C) Any other method, with the prior approval of the Commissioner.

A broker must keep adequate records of the determination so made.

(ii) *Method of allocation and selection*--(A) *Allocation to individual and nonindividual pools.* With respect to each substitute payment in lieu of a dividend received by a broker, the broker must allocate the transferred shares (*i.e.,* the shares giving rise to the substitute payment) among all shares of stock of the same class and issue as the transferred shares which were (1) borrowed by the broker, and (2) which the broker holds (or has transferred in a transaction described in paragraph (a)(1) of this section) and is authorized by its customers to transfer (including shares of stock of the same class and issue held for the broker's own account) ("loanable shares"). The broker may first allocate the transferred shares to any borrowed shares. Then to the extent that the number of transferred shares exceeds the number of borrowed shares (or if the broker does not allocate to the borrowed shares first), the broker must allocate the transferred shares between two pools, one consisting of the loanable shares of all individual customers (the "individual pool") and the other consisting of the loanable shares of all nonindividual customers (the "nonindividual pool"). The transferred shares must be allocated to the individual pool in the same proportion that the number of loanable shares held by individual customers bears to the total number of loanable shares available to the broker. Similarly, the transferred shares must be allocated to the nonindividual pool in the same proportion that the number of loanable shares held by nonindividual customers bears to the total number of loanable shares available to the broker.

(B) *Selection of deemed transferred shares within the nonindividual pool.* The broker must select which shares within the nonindividual pool are deemed transferred for use in a short sale (the "deemed transferred shares"). Selection of deemed transferred shares may be made either by purely random lottery or on a first-in-first-out ("FIFO") basis.

(C) *Selection of deemed transferred shares within the individual pool.* The broker must select which shares within the individual pool are deemed transferred shares (in the manner described in the preceding paragraph) only with respect to substitute payments as to which a statement is required to be furnished under paragraph (a)(2)(ii) of this section.

(3) *Examples.* The following examples illustrate the identification of customer rules of paragraph (f)(2):

Example (1). A, a broker, holds X corporation common stock (of which there is only a single class) in street name for five customers: C, a corporation; D, a partnership; E, a corporation; F, an individual; and G, a corporation. C owns 100 shares of X stock, D owns 50 shares of X stock, E owns 100 shares of X stock, F owns 50 shares of X stock, and G owns 100 shares of X stock. A is authorized to loan all of the X stock of C, D, E, and F. G, however, has not authorized A to loan its X stocks. A transfers 150 shares of X stock to H for use in a short sale on July 1, 1985. A dividend of $2 per share is declared with respect to X stock on August 1, 1985, payable to the owners of record as of August 15, 1985 (the "record" date). A receives $2 per transferred share as a payment in lieu of a dividend with respect to X stock or a total of $300 on September 15, 1985. H closes the short sale and returns X stock to A on January 2, 1986. A's records specifically identify the owner of each loanable share of stock held in street name.

From A's records it is determined that the shares transferred to H consisted of 100 shares owned by C, 25 shares owned by D, and 25 shares owned by F. The substitute payment in lieu of dividends with respect to X stock is therefore attributed to C, D and F based on the actual number of their shares that were transferred to H. Accordingly, C receives $200 (100 shares x $2 per share), and D and F each receive $50 (25 shares each x $2 per share). A must furnish statements identifying the payments as being in lieu of dividends to both C and D, unless they are exempt recipients as defined in paragraph (b)(2) of this section or exempt foreign persons as defined in paragraph (b)(3) of this section. Assuming that A has no reason to know on the record date of the payment that the dividend paid by X is of a type described in paragraph (a)(3)(ii)(A)-(D) of this section, A need not furnish F with a statement under section 6045(d) because F is an individual. (However, A may be required to furnish F with a statement in accordance with section 6042 and the regulations thereunder. See paragraph (h) of this section.) By recording the ownership of each share transferred to H, A has complied with the identification requirement of paragraph (f)(2) of this section.

Example (2). Assume the same facts as in example (1), except that A's records do not specifically identify the record owner of each share of stock. Rather, all shares of X stock held in street name are pooled together. When A receives the $2 per share payment in lieu of a dividend, A determines the identity of the customers to which the payment relates by the method of allocation and selection prescribed in paragraph (f)(2)(ii) of this section. First, the transferred shares are allocated proportionately between the individual pool and the nonindividual pool. One-sixth of the transferred shares or 25 shares are allocated to the individual pool (50 loanable shares owned by individuals/300 total loanable shares = 1/6; 1/6 x 150 transferred shares = 25 shares). Assuming A has no reason to know by the record date of the payment that the payment is in lieu of a dividend of a type described in paragraph (a)(3)(ii)(A)-(D) of this section, no selection of deemed transferred shares within the individual customer pool is required. (However, A may be required to furnish F with a statement under section 6042 and the regulations thereunder. See paragraph (h) of this section.) Five-sixths of the transferred shares or 125 shares are allocated to the nonindividual pool (250 loanable shares owned by nonindividuals/300 total loanable shares = 5/6; 5/6 x 150 transferred shares = 125 shares). A must select which 125 shares within the nonindividual pool are deemed to have been transferred. Using a purely random lottery, A selects 100 shares identified as being owned by C, and 25 shares identified as being owned by D. Accordingly, A is deemed to have transferred 100 shares and 25 shares owned by C and D respectively, and received substitute payments in lieu of dividends of $200 (100 shares x $2 per share) and $50 (25 shares x $2 per share) on behalf of C and D respectively. A must furnish statements to both C and D identifying such payments as being in lieu of dividends unless they are exempt recipients as defined in paragraph (b)(2) of this section or exempt foreign persons as defined in paragraph (b)(3) of this section. A has complied with the identification requirement of paragraph (f)(2) of this section.

*Source: IRS letter ruling number 8546032 dated 8/19/85

Appendix C2

Proxy Proration Example*

	Long	Short	Vote Yes	Vote No
DTC		13,000		
Cust A	1,000		1,000	
Cust B	2,000			2,000
Cust C	3,000		3,000	
Cust D	4,000		4,000	
Cust E	5,000		5,000	
Cust F		2,000		

Customers Long 15,000 shares

DTC box 13,000 shares

Total Yes Votes 13,000

Total No Votes 2,000

We need to reduce our total votes by 2000 . That is 13.33 per cent of our overall total votes .
We would reduce the Yes votes by 13.33 % (1,733)
We would reduce the No votes by 13.33 % (267)
***Assumes all clients have margin accts (no cash accts) with outstanding balances,**
so all accounts are subject to proration.

Appendix C3

Impartial Lottery Example*

	Long	Short	Voteable Shares Pre lottery	Voteable Shares Post Lottery 1	Voteable Shares Post Lottery 2	Voteable Shares Post Lottery 3	Voteable Shares Post Lottery 4
				New client positions after running four separate lotteries			
DTC		13,000					
Cust A	1,000		1,000	0	0	1,000	1,000
Cust B	2,000		2,000	2,000	2,000	2,000	2,000
Cust C	3,000		3,000	3,000	3,000	3,000	3,000
Cust D	4,000		4,000	3,000	4,000	2,000	4,000
Cust E	5,000		5,000	5,000	4,000	5,000	3,000
Cust F		2,000	0	0	0	0	0
Total Votes			15,000	13,000	13,000	13,000	13,000

Customers Long 15,000 shares

DTC box 13,000 shares

We need to reduce our total votes by 2000

Shading shows amount of new voteable share positions

***Assumes clients A, D and E have margin accounts (no cash accts) with outstanding balances and clients B,C and F do not participate in the lottery because they are short or fully paid with no margin balances**

Appendix D, Summary of the current NYSE rules governing records and record retention

Proxy Records –
NYSE 452.16 Records covering the solicitation of proxies show the following:

1. The date of receipt of the material from the issuer or person soliciting the proxies
2. Names of customers to whom the material is sent together with date of mailing
3. All voting instructions showing whether they are verbal or written
4. A summary of all proxies voted by the member organization clearly setting forth total shares voted for, against or not voted for each proposal to be acted upon at the meeting

Retention of Records –
NYSE Rule 452.20 - All proxy solicitation records, original of all communications received and copies of all communications sent relating to such solicitation, shall be retained for a period of not less than three years, the first two years in an <u>easily accessible place.</u>

CAD SUMMARY OF NYSE SPECIAL PROXY EXAMINATIONS

The NYSE provided a draft of the Special examinations, to me, John Panchery SIA and Don Kittell SIA that were conducted of eight (8) member organizations. The NYSE conducted these examinations to determine the adequacy of member organizations written supervisory procedures and monitoring efforts with respect to proxy voting.

The member organizations' books and records were reviewed to determine the accuracy of proxy voting relating to annual shareholders' meetings of the companies selected for review. The actual member organization names were not disclosed. However, the names of the Companies Annual Meetings were included in the findings provided.

The NYSE stated that the objective of the examinations was to determine the member organizations' compliance with various Rules including the NYSE Rules listed below.

The examinations disclosed deficiencies at each member organization and the following 9 Rules were cited in the various examination reports, and in varying degrees of non compliance.

- NYSE Rule 342 (Offices – Approval, Supervision and Control)
- NYDE Rule 401 (Business Conduct)
- NYSE Rule 451 (Transmission of Proxy Material)
- NYSE Rule 451.90 (Schedule of Approved Charges by Member Organizations In Connection With Proxy Solicitations)
- NYSE Rule 452 (Giving Proxies by Member Organizations)
- NYSE Rule 452.20 (Retention of Records)
- NYSE Rule 440 (Books and Records)
- SEC Reg. 17a-3 (Records to be Made by Certain Exchange Members, Brokers and Dealers)
- SEC Reg. 17a-4 (Records to be Preserved by Certain Exchange Members, Brokers and Dealers).

The following is a summation of the findings as stated in the NYSE Audit Summary.

1. Member Organizations could not provide written & documented procedures.
2. Supervisory review of the proxy process was not found.
3. The NYSE states that Member Organizations can not outsource their responsibilities.

4. Record retention: All documents must be easily accessible, and presented upon request.
5. Independent Audit Reviews, internally and externally of their internal records, controls & procedures. No evidence of review.
6. Position Balancing and Adjustments. Reconciliations were not conducted
7. Securities / Share on loan can not be included in the voteable position.
8. Independent Audit Reviews of the Proxy Service Provider, (ADP) was not conducted.
9. Billing Control's, & Procedures with ADP, no reconciliation was completed.
10. Reconciliation of records to assure that beneficial Owners Votes were accurate prior to the stock record being sent to the Service Provider.
11. Supervisory Review of the Service Provider (ADP), to ensure compliance with Proxy Rules & Regulations was not maintained.
12. Proprietary Long Positions were not netted against, Proprietary Short Positions, and Securities Borrowed was included in Long Positions. Thus resulting in over voting.
13. Member Organizations entire long positions, net of securities borrowed was used for voting purposes. There were no other attempts to modify the proxy summaries to adjust for beneficial owners, which resulted in overvoting.
14. No Independent Supervisory review of proxy voting results complied by ADP, It's Service Bureau, Rule 342.
15. Firms did not net customers long positions against related short positions prior to voting the long shares.
16. Pledged Margin Option Positions can not be voted.

Overvote Analysis from 2006 Proxy Season

Reports gathered by STP Advisory Service, LLC

Agent #1:

Number of Meetings 1/1/06 – 6/9/06: 146

Number of Meetings 1/1/06 – 6/9/06 with at least one overvote occurrence: 140

(90% of the occurrences of over-voting were traced to DTC Participants.)

10 Examples of True Overvotes

CO#	NOMINEE	R/D CEDE POS.	ADP VOTE	OVERVOTE
1%	GS Int'l	70,008	287,390	217,382
2%	Nat'l City Bank	47,782	48,138	356
3%	Scottrade	223,580	528,152	304,572
	Stifel Nicolaus	0	25,000	25,000
	UBS Fin'l	0	182,892	182,892
	UBS Securities	0	11,660	11,660
	USAA Brokerage	0	14,015	14,015
	Wedbush Morgan	0	123,200	123,200
4%	Interactive Brokers	1,196	18,396	17,200
5%	Interactive Brokers	11,675	13,008	1,333
	Nat'l Fin'l Serv	4,995,444	5,142,434	146,990
6%	Terra Nova	2,000	5,000	3,000
	UBS Securities	4,550	53,800	49,250
7%	Interactive Brokers	71,692	75,492	3,800
	UBS Securities	0	149,600	77,717
	USAA Brokerage	94,985	99,985	5,000
8%	Northern Trust	164,413	190,626	26,213
9%	Huntington Banks	69,221	84,000	14,779
10	Bear Stearns	2,434,159	2,486,727	52,568

(R/D = Record Date)

(CEDE = DTCC Nominee Name)

(ADP = Automated Data Processing, industry utility for proxy vote submission)

Agent #2

# of Meetings since 1/1/06 - 6/09/06: 51

# of Meetings with over-voting: 30

# of over-voting occurences: 48

We did have two large over-votes (3.9 million and 1.3 million shares) posted by Credit Suisse, in a company for which they did not have a position at DTCC.

Inspector of Election #1

It seemed statistically certain to me that most of the company's individual investors did NOT receive the proxy materials from ADP in timely fashion. ADP certainly seemed "over-stressed" this year. They tried to tell me that there were "problems with slow delivery of 'standard mail' "- but upon further inquiry, it turned out that they had used a special UPS service to deliver directly to postal-distribution centers around the country, which normally assures faster delivery not slower. Packages seem to have disappeared at ADP. Yet another client told me that while ADP "began mailing" in timely fashion, they didn't finish until nearly three weeks had passed.

Treating Shareholders Equally: c Alternatives for Street Proxy Distributions c

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instructions.are.mailed. to.parties.that.should. not.be.authorized.to. vote. At.times,.this. can.result.in.votes. being.discounted.and. **the real owners unknowingly losing their voting power** or,. in.some.cases,.they.are. ignored.

monopolistic environment which includes pricing abuses and lack ofx a complaint review process.x

The United States continues toLrecognize a process that consists of substandardL voting rights for beneficial shareholders and non-negotiable pricing.LThe nextL section will outline, in greater detail, the conditions that exist in the current proxyL distribution process, and a solution, similar to one recently adopted in Canada, willL be provided as an alternative. This White Paper is intended to identify the flawsL thatL
exist in the current process and offer solutions utilizing models from both theL Canadian market experience and existing market elements already in place in theL United States.LThe proposed solution will provide the following:L

1.LProcesses that ensure that beneficial positions are reconciled in order toL prevent over-voting.L
2.LProcedures and practices that ensure accurate, timely distribution ofL materials and equitable voting rights for beneficial shareholders.L
3.LA structure wherein the issuer has responsibility for selecting its proxyL material distributor and tabulator.L

Over the decades, numerous requests have been made for a review of the currentL proxy system.LThese requests have been met by ad hoc committee reviews thatL have reduced prices for the largest companies, while doing little to improve theL integrity of the system and provide broad-based, open market competition.LAd hocL committees cannot overhaul the street proxy process.LThe United States mustL address the archaic process of restricting issuers access to street name positions forL distributing voting rights to beneficial shareholders, if it wants to be a leader in theL areas of corporate governance and open-market practices.L

STA Newsletter
2005 – Issue 4
The Securities Transfer Association, Inc. A PUBLICATION OF THE SECURITIES TRANSFER INDUSTRY
Established 1911

Excerpt

Street Proxy Tabulation Results:
0ver-Voting Still Pervasive

During the 2005 proxy season, one major transfer agent conducted a thorough review of all street proxies submitted for banks and brokers through ADP. The objective of the review was to ensure the accuracy of the voting and to assess the progress in addressing over-voting and other voting conditions. The agent tabulated 341 U.S. equity issuers. Attempted over-voting of street positions occurred for every tabulation! The following is a summary of causative factors observed:

…

<u>Simple Over-Votes</u>: The agent continued to see over-votes cast by DTC participants, who, when contacted, simply explained that the excess voting is attributable to the brokers stock loan services or other trading-related situations.

Discussion - Over-voting continues to be a problem. The SIA letter indicated that a resolution for this situation was a lottery or pro-ration of voting rights when commingled shares are on loan. This solution has clearly not been implemented across the board. ADP's over-voting service, in its weakest implementation, resolves the issue by simply capping a participant's vote at its DTC record date position. This neither effectively addresses the issues regarding integrity of voting rights nor the excess issuer cost caused by mailing of materials to holders not entitled to vote.

…

Summary and Conclusions

Street voting problems continue to abound. The over-voting services provided by ADP clearly do not address the issues created by stock lending, trade fails and other record date brokerage record deficiencies. The street proxy system lacks audit accountability required of meeting inspectors and is still too costly and difficult for issuers to effectively communicate with their shareholders. Some improvements were made, but the basic integrity of the system is still questionable. After a year plus of industry proxy committee meetings, the underlying issues appear to remain.