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December 8, 2006

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

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

Dear Secretary :

I feel it is important to bring to the attention of the Commission, the risk exposure that REG SHO, as currently written, exposes the US equity and derivative markets to. This risk exposure is so large that once understood, it should compel the Commission to amend REG SHO to eliminate this risk exposure.

The risk exposure can be executed with a **Dividend Capture Strategy** and will be detailed bellow. The financial markets in this country are in far greater risk of mere price manipulations of securities, due to the way REG SHO is currently written. Cash could be stripped out of the market and from broker-dealers until there is no more liquidity left. This risk exposure is created by the way investor accounts are currently permitted to be treated by the SEC and by the existing exemptions to the Securities Exchange Act of 1934 currently in REG SHO. Specifically, the issuance of "securities entitlements; in far greater numbers than the number of outstanding issuer issued securities and no controls to correlate the two is the culprit. To make matters worse, this cash liquidity can be sucked out of the markets risk free by any domestic or foreign party executing the strategy and it wouldn't even be noticed until a substantial amount has already been removed from our markets.

Description of the Dividend Capture Strategy

The Number of Issued Securities Vs. The Number Held by Investors

When investors purchase securities, their broker-dealers confirm these purchase transactions as defined under rule 10b-10 by, among other things, crediting securities to their accounts. However, broker-dealers sometimes fail to obtain the purchased securities at the time the purchase transactions are confirmed to investors (even after T+3) or to maintain them after they have been obtained and trades confirmed. In these cases, broker-dealers credit “securities entitlements” to investor accounts in lieu of real issuer issued securities. The Commission has explained in its Nanopierce Amicus Curiae Brief that broker-dealers can rely on the authority of U.C.C. Article 8 to credit “securities entitlements” to investor accounts in lieu of issuer issued securities that investors have purchased through them and that the crediting of “securities entitlements” by broker-dealers to investor accounts can complete and confirm the purchase transaction for the investors. However, crediting “securities entitlements” to investor accounts increases the number of securities in investor accounts over and above the number of securities the issuer has issued.

Securities Lending further increases the number of “securities entitlements” credited by broker-dealers in investor accounts and the total number of securities in investor accounts, because when real securities held on behalf of investors are lent out by broker-dealers, the lent securities are not debited from investor accounts. The shortfall in the number of issuer issued securities broker-dealers have Vs. the number of securities the broker-dealers have credited to investor accounts is then accomplished by crediting “securities entitlements” to investor accounts in place of the lent issuer issued securities. Retail investors are not even aware when this happens.

In certain cases, some broker dealers have actually had little or no issuer issued securities on hand in any depository while crediting their investor clients almost exclusively with securities via “securities entitlements”. A recent example are City Securities, Daiwa Securities and Lazard Ltd., that credited a total of 1,280,772 “securities entitlements” of OSTK with a market value of $34,888,229 to investor accounts while only holding a total of 50 OSTK issued securities as of January 12, 2006.

For all of the sampled broker-dealers in the case of OSTK on this date, the broker-dealers were found to have issued 6,703,630 more securities in the form of “securities entitlements” to investor accounts and thus short an equal number of OSTK issued securities, with a value of over $180 Million Dollars.

Several other companies have been able to determine that the number of their securities held by investors exceeds the number of securities they have authorized and issued and the list of companies exploring and discovering this is growing quickly.

In a recent Securities Industry Association consolidated report, **just for NYSE issues alone** in Q2 of 2006, the market to market value of FTDs by reporting firms is $28 billion. This is far higher than the $3 Billion reported by the DTCC for all exchanges, **not just the NYSE**, probably because the DTCC doesn’t see all FTDs and because they only see post CNS netting figures.

The evidence is clear that the combined aggregate number of securities and securities entitlements credited in investor accounts by broker-dealers far exceeds the number of issuer issued securities by tens of billions of Dollars.

Nothing directly limits the number of securities credited to investor accounts according to the total number of securities the issuer has issued. There is no control. However, when broker-dealers freely credit securities entitlements, they also freely and willingly take on the risk exposure of doing so and have thus in aggregate exposed the entire financial market in the U.S to this risk. However, no control means no risk control either.

Dividend Payment Obligations by Broker-Dealers

Despite the fact that broker-dealers issue "securities entitlements" in lieu of issuer issued securities to investor accounts, broker-dealers are still required to treat persons for whom the accounts are maintained as entitled to exercise the same rights that compromise the issuer issued securities. The Commission cites this obligation on the part of broker-dealers under UCC Sections 8-104 and 8-501 in the aforementioned Nanopierce Amicus Curiae Brief. Further, as per the 1978 Securities Exchange Act Release No. 15194 and NASD rules, broker-dealers are required to make prompt dividend, paid in-lieu and interest payments to investor accounts. It's clear then that even if broker-dealers credit investor accounts exclusively with "securities entitlements" that the broker-dealers in question are still obligated to promptly pay dividends in the form of PIL, if the underlying issuer of the security declares and pays a dividend.

Basic Strategy

Broker-dealers credit more securities in investor accounts than issuers have issued, thus creating more rights to dividends than the issuer has to an obligation to pay, in exchange for assuming risk exposure. The strategy seeks to capture as many PIL payment obligations as possible from broker-dealers that results from their risk exposure, in addition to regular dividend payments.

The strategy is not reliant on the purchase, sale or borrowing of any securities or acquiring any voting rights, taking control of the issuer or a change in the price of any securities. The strategy itself merely profits by collecting dividends and PIL. No trading need take place.

Example

In a simplified example, if Strategy Investors agree to capitalize a company with 100 million Dollars on the condition that 90% of it be distributed to share holders within 60 days, as a return of capital via dividends, whereby the issuer has 20 million securities outstanding, but for which Strategy Investors can find and arrange to borrow 30 Million dividend rights – Strategy Investors would receive $135,000,000 in the form of dividends and PIL – $35 million more than was invested to capitalize the issuer, while the issuer retains $10,000,000.

Thus, brokers who credited "securities entitlements" to investors in excess of issuer issued securities will be liable for paying $35 Million to investors as PIL. If brokers refuse, investors would certainly seek a civil suit to enforce their rights to receive dividends or PIL from their brokers.

If this is repeated often enough, at some point cash liquidity will be insufficient to cover the PIL payments that brokers are be liable for. This would certainly tumble the financial market into a crisis.

What's worse is that broker-dealers have no way to close out the positions and remove their liability and risk exposure once it is established. The investors who have paid for the "securities entitlements" issued by the broker-dealers have the sole discretion to sell or hold on to these indefinitely. There is nothing broker-dealers can do to remove these "securities entitlements" from the market once they have been issued, except to by buying an equal number of issuer issued securities themselves – if they can find any willing sellers.

The main reason “securities entitlements” are credited by brokers to investors is due to delivery failures.

Since almost all broker-dealers and derivative market makers engage in the practice of delivery failures or issuing “securities entitlements” to the market, it would only require a small number of securities involved in a Dividend Capture Strategy to impact and endanger just about every single equity and derivative broker-dealer and market maker and thus the financial market of the U.S.

This type of risk free scheme is tailor made for money launderers and foreign entities wishing to harm the U.S. financial markets. It is very easy, as shown in documented cases, where broker-dealers have sold more “securities entitlements” than the number outstanding issuer issued securities – to just one single account. It boggles the mind to think how many “securities entitlements” an entity could acquire through hundreds of accounts. It is not difficult for one entity to control a larger number of “securities entitlements” and dividend rights in excess of what issuers are obligated to pay in dividends.

Conclusion

The complete lack of controls in the issuance of “securities entitlements” by broker dealers to the market and investors in relation to the number of issuer issued securities means there is no risk control to the U.S financial system from this discrepancy. This risk must be removed before it’s exploited, as it most certainly will otherwise. Worse, the exploitation of this risk exposure doesn’t even require any trades or a price movement while being executed, making it almost impossible to detect. There are also no laws or rules forbidding exploiting this risk exposure when investors simply demand dividends on all securities in their accounts.

If the commission would simply enforce the Securities Exchange Act of 1934 and remove the Commission’s exemptions permitting delivery failures, this risk exposure would be eliminated. “Securities Entitlements” issued due to securities lending can be closed out at any time by broker-dealers simply recalling the lent shares, unlike broker issued “securities entitlements” credited to investor accounts in exchange for their cash.

While there are many more reasons to amend REG SHO and to eliminate the exemptions to the Securities Exchange Act of 1934 that permit deliberate delivery failures, this risk exposure to the market is but one of them.

Sincerely submitted,

Thomas Vallarino