Thomas Vallarino

March 27, 2007

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 am responding to the SEC's renewed request for comments, to the amendment of SEC rule 203, that the commission justifies by data supplied to the SEC by the NASD on delivery failures (FTD).

It is a wonder why the SEC needs to give such great importance to such a slim slice a carefully mined data, provided by the NASD, rather than the SEC relying on the mountain of data it receives every single day on all FTDs.

Useless FTD Data provided by the NASD

To illustrate how useless the NASD data is for the SEC in evaluating the magnitude and the effects and causes of delivery failures, let me highlight certain screening criteria used by the NASD :

1. Screens out securities, unless they have appeared on the NASD Threshold list
2. Screens out securities, unless they have appeared on the threshold list for at least 40 days
3. Screens out securities, unless they have appeared on the threshold list from January 10, 2005 through August 11, 2005
4. Fails to give any absolute or conclusive number of delivery failures. Rather, the sole focus is on the number of issues.

By the time a security even gets reported to the Threshold list and becomes a threshold security, there can already be an unlimited number of FTDs in the security, as it takes weeks before the security even gets on the threshold list. However, the NASD data contains no conclusive data on the number of delivery failures at all.

It is possible that while the number of issues on the threshold list in the screened NASD sample goes down, that the absolute number of delivery failures goes up.

The NASD data on which the SEC is relying, is useless in determining the magnitude and trend of delivery failures, as no delivery failure data is even provided. Nor can the SEC determine the harm and the effects FTDs and FTRs have on all parties the SEC is charged with protecting.

In addition, if the SEC is concerned about reducing manipulative trade practices via delivery failures and the harm done to investors and the public, the SEC must be concerned with stopping securities from becoming threshold securities in the first place. Once they are on the threshold list, investors have already been harmed.

Also, the NASD report has no definitive conclusions about the reasons why issues become threshold securities. The NASD letter qualifies the causes of with **"could be", might be", "appear to be", "might have been"**, etc…The NASD should definitively know.

Without a definitive conclusion and delivery failure numbers, the SEC **can not rely** on this NASD data. The data is screened in such as way as to be useless to be relied upon for formulating formal rules in the SEC's regulatory scheme to amend rule 203 of REG SHO. Rather than relying on this data, the SEC **should discarded the data supplied by the NASD because it says nothing as to the causes of issues becoming threshold securities, remain threshold securities and reveal nothing on the number of delivery failures nor the effectiveness the existing rule.**

Representative Data on the Number of FTD and Issues Affected

However, more representative FTD data is **already** available to the SEC :

Data from a Freedom of Information Act (FOIA) request for the total number of failed deliveries on the NYSE shows that on REG SHO's commencement date, January 03, 2005, there were 65 million shares of failed deliveries in NYSE issues, with a total of 552 total issues with greater than 10 thousand delivery failures. On the last date for which data was provided, May 31, 2006, there were 65 million shares of failed deliveries in NYSE issues, and there were 590 total issues with over 10 thousand delivery failures.

Simply put, REG SHO has had no appreciable result in limiting either the number of FTDs, nor the number of issues affected, judging by the NYSE data - in fact, the number of issues with more than 10,000 shares that failed delivery has increased. In another FOIA release by the SEC, it is seen that on the OTCBB, the number of delivery failures actually increased by the end of the reporting period, from 585 million shares at the commencement of REG SHO, to 679 million shares on May 31, 2006.

The careful selection criteria of FTD data by the NASD provided to the SEC is carefully chosen to make the appearance of a minimal impact on the market, the total number of issues and total number of shares that suffer from fail to deliver. However, the above data are the real and **complete numbers** available to the SEC for analysis that show a different picture.

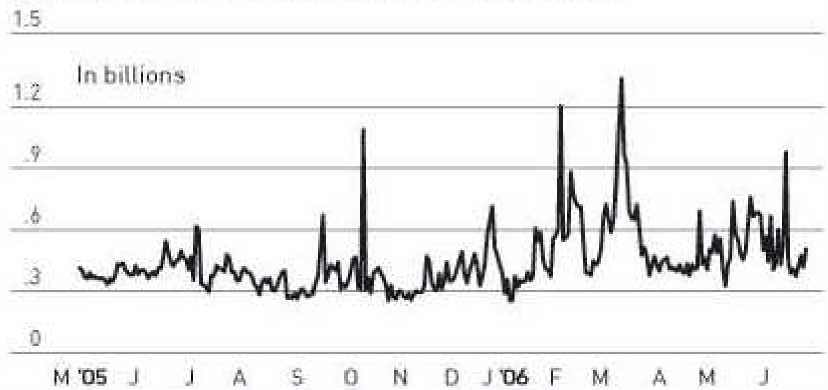
However, even the NASD data doesn't hide the fact that the **market maker exception** and the **grandfather clause,** "probably", "may", "appear to be" the cause of the delivery failures. Not even they dispute this.

The charts bellow visualize the more complete data from across various exchanges from information released by the SEC itself and available to the SEC at any time.

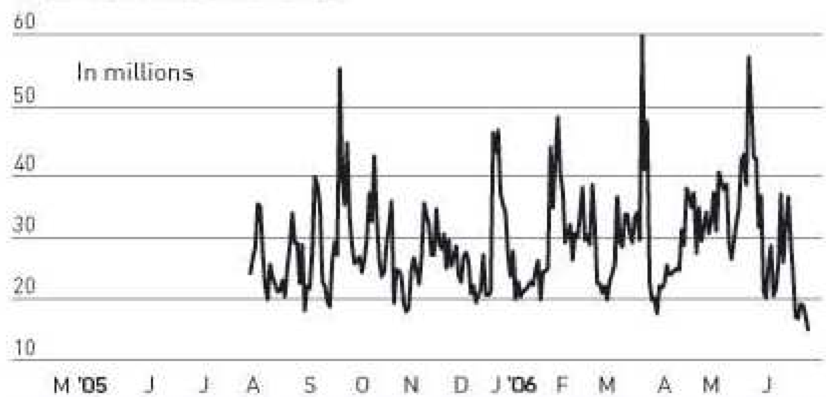
'Missing' Shares

The SEC's daily tally of failed to deliver shares, from May 2005 through June 2006, showed no clear downward trend

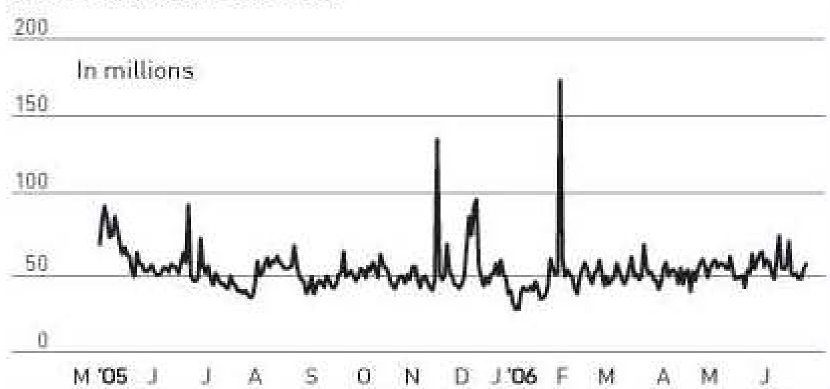
Nasdaq and over the counter failed to deliver shares



Amex failed to deliver shares



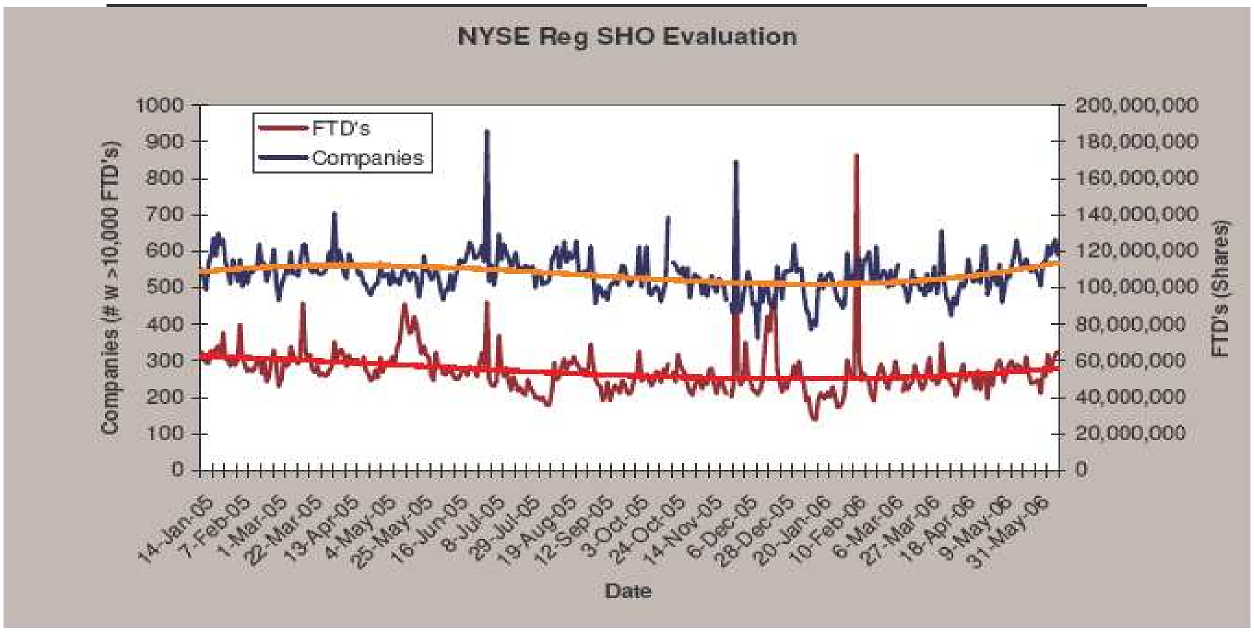
NYSE failed to deliver shares



Source: SEC

Example I. (Failed SHO Evaluation)

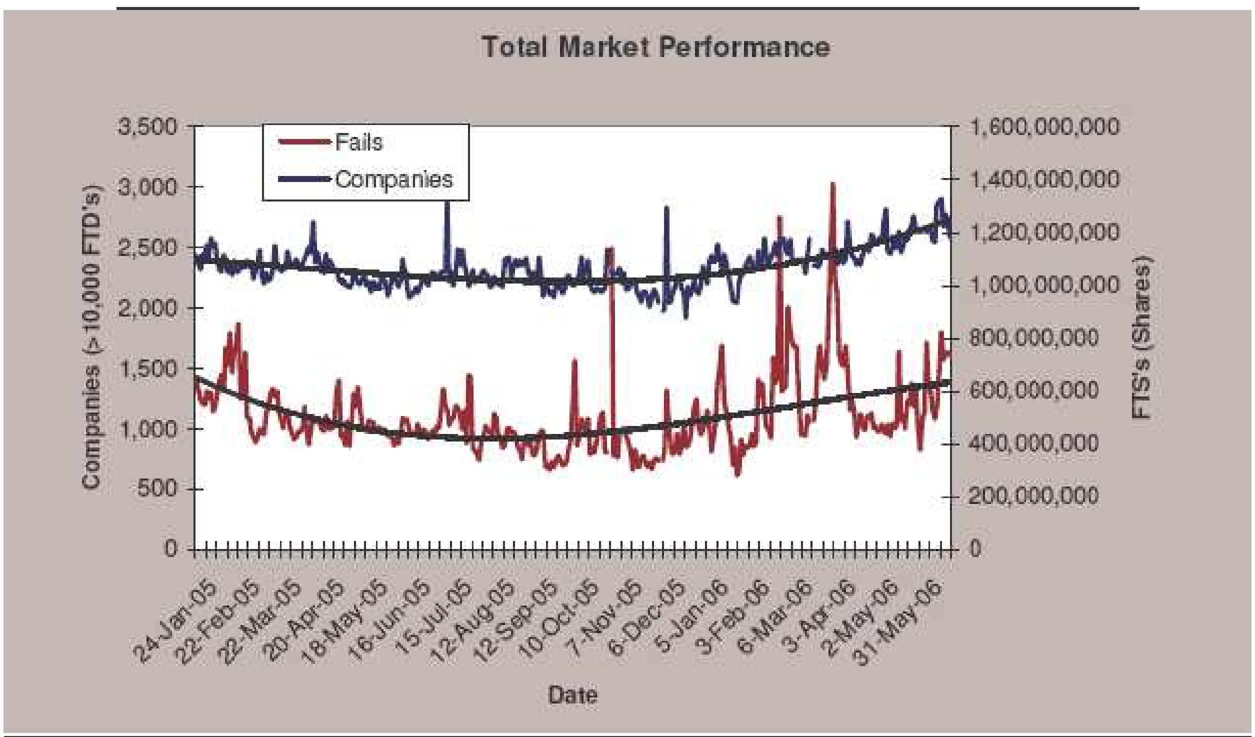
NYSE Fail to Deliver Data as plotted from FTD Data received from the SEC under FOIA #06-06997



Data illustrates a lack of success in reducing the level of fails over time and illustrates a lack of success in reducing the level of companies with greater than 10,000 fails over time. The numbers for both of these categories were higher on May 31, 2006 than seen on January 3, 2005 when SHO first became law.

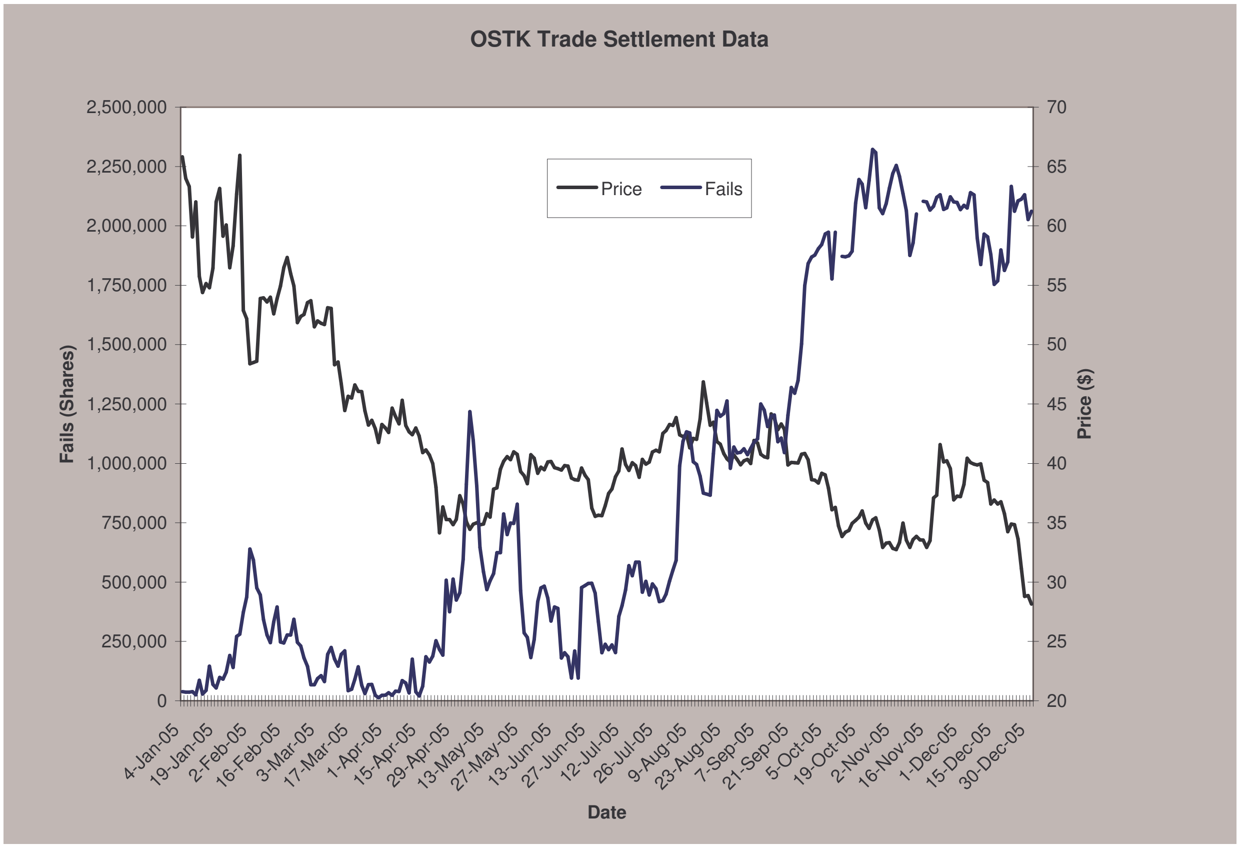
Example II (Failed SHO Evaluation)

Data based on a combination of FTD reports provided by the SEC. The NYSE FOIA used above FOIA #06-06997 and FOIA #06-07003 representing aggregate fails in the NASDAQ, OTCBB, and Pink Sheet Securities.



Example III (FTD correlation to price)

This chart of settlement failures (blue line) Vs. share price (Green Line) shows that there is a direct relationship over the course of one year between the number out outstanding delivery failures and the share price. The more FTDs there are, the lower the share price.



FTDs and FTRs Are Unregistered Securities

The 1933 and 1934 Security Acts clearly define that instruments such as FTDs and an FTRs, issued by the settling agents to the failing sellers and buying counter parties, are clearly securities as defined by the Securities Acts. As such they are required to be registered and obtain their own trade symbol before they can be credited to investors, much less hijack the trade symbol of another registered security.

However, this is not the case now, and is in direct violation with the provisions of the Securities Acts that require these to be registered. If the SEC had promulgated a formal rule permitting the sale of unregistered securities, this would not be an issue. However, the SEC has never done so and in my opinion, could never justify if it tried.

Not enforcing the provisions of the Securities Acts that prohibit the sale and trade of unregistered securities is one cause of delivery failures. If the SEC would enforce just this one provision that it is obligated to enforce, it would halt all sales of unregistered securities and impose steep fines on the perpetrators – all by itself. The trade of unregistered securities has never been legal and has never been the intent of Congress to ever permit. It is expressly prohibited in both the 1933 and the 1934 Securities Acts.

When Does a Securities Entitlement Become an Unregistered Security?

The legitimate use of "securities entitlements" is perfectly fine. These are to indicate to buyers that delivery is imminent from the settling agent and still within the contracted time frame of T+3. These are also used by broker-dealers to notify investors who buy securities through broker-dealers, rather directly from the market, the type and quantity of registered securities the broker-dealer holds on behalf of the investor or is expecting imminent delivery within the contracted time frame.

Once the contacted time frame is exceeded and a delivery failure occurs, "securities entitlements" cease to exist and become unregistered securities. These unregistered securities have been delivered and are held by the buying counterparty.

The distortion goes unnoticed for quite some time because, not only are these securities not registered, but they also hijack the trade symbol of the registered security they displace. In addition, SEC rules permit the difference of the market to market value of the unregistered security Vs. the original purchase price to be released to the seller of the unregistered security, rather than withholding all funds until delivery of the registered security.

Intent of Congress

The creation of the SEC and the 1933 and 1934 Securities Acts sprung from the U.S. Senate Pecora hearings of 1932. The intent of congress can be read in the transcripts of those hearings and the concerns of the lawmakers at that time and their reasoning in writing the provisions in the Securities Acts.

Basically they wanted to bring order to the securities markets and fix many of the structural problems that made the 1929 crash possible. One of those fixes that was **clearly** their intent, was to block any sort of naked short selling that result in FTDs, as we know it today.

This intent is abundantly and repeatedly expressed in many areas of the Acts. Any one provision alone would make delivery failures impossible, much less all concurrently :

1. The prohibition on the sale of securities without a change in beneficial ownership
2. The requirement to closely **LINK** clearing and settling
3. The requirement that all trades **promptly settle**
4. The requirement that **transfer of record ownership** be prompt
5. The requirement to **register** most securities with the SEC before they are sold
6. The requirement for the SEC to make formal rules that are **consistent with the protection of investors**

Delivery failures violate all of the above requirements that Congress expressly intended and charged the SEC with enforcing. There for, delivery failures of securities violate the intent of Congress as expressed by the above requirements contained in the acts and expressed in the congressional transcripts that discuss the reasons for the creation of these provisions in the acts and the SEC itself. The SEC is not permitted to undermine the will of the people by ignoring these requirements, but rather is charged with enforcing them.

The intent of congress was to stop all forms of delivery failures by all parties. This is abundantly clear and the SEC has failed in this simple mission by permitting FTDs to continue and even giving certain parties advantages over regular.

If the SEC really wanted to protect investors, as it is charged with doing and is the SEC's number one responsibility, the SEC would enforce the provisions of the 1933 and 1934 securities acts and the will of Congress, and prohibit delivery failures of all kinds. Not only is it good for investors and protects them, it is required by provisions of the securities acts.

SEC Favoritism

In light of the will of the Congress and the job given to the SEC by Congress, it is incomprehensible how the SEC can play favorites in its regulatory scheme by dealing out trade advantages to one investor group over another. It is even more appalling to see that this SEC favoritism comes at the expense and harms the very investors it is charged with protecting.

Anything the SEC does must steer clear of harming investors. Unfortunately, delivery failures not only make price discovery of a security impossible, it makes the manipulation of the price point possible. It makes harm to investors not only probable, but a certainty. Top this off with only permitting certain broker-dealers from failing to deliver and sell FTDs, at the expense of regular investors, but prohibiting regular investors from doing the same, then it is clear that delivery failures as a policy by the SEC is unsupportable based on any reading of the Securities Acts, the responsibilities of the SEC and the intent of Congress.

Delivery failure as a policy does not even assist in orderly markets, when price discovery of a security is distorted with the injection of FTD securities that are sold to investors in place of another security. Especially when these FTD securities are neither registered nor have a proper trade symbol of their own, but rather fool investors into investing good money on a fraudulent representation by hijacking another security's trade symbol for itself.

Favoritism and permitting investors to be harmed is in violation of the will of congress as expressed in the 1933 and 1934 Securities Acts and the mandate the SEC has to protect all investors. Section 36 of the 1934 Act, only allows the SEC to create exemptions to the 1934 Act, **"…to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors…"**

Statements by SEC Chairman Cox

On March 14, 2007, during a Capital Markets Summit, hosted by the U.S. Chamber of Commerce, SEC Chairman Cox made statement that all but agree with the points this letter also is trying to make. Namely, that REG SHO has failed in its purpose and delivery failures continue despite REG SHO and harm investors. Here the pertinent transcript of Chairman Cox's statements:

> Audience Member: Chairman Cox, Jonathan Johnson, Overstock.com. You have mentioned in the past that abusive naked short selling is being used to manipulate stock prices down to the detriment of investors. Last month, the Chamber sent a letter requesting that Congress hold hearings on the issue and last night Bloomberg

> TV ran a piece, a special report, on this issue. What is the commission doing to stop this form of manipulation and when can we expect some expect some action?
>
> CHAIRMAN COX: Abusive naked short selling is of great concern to the entire Commission, to all of our members and the professional staff at the SEC. The regulation that was first adopted to get after this and related problems, **REG SHO, has proven insufficient to stop the problem. One of the reasons is the Grandfather provision in the rule as it was originally adopted, so we are now setting out, as you know, to eliminate that grandfather provision**………**And I know that people victimized by it have a great deal of right on their side to complain about it.**
>
> CHAIRMAN DONAHUE: You have a lot of support from here in getting that done. Just let us know how we can **get some muscle behind it. It is a serious challenge**.

So it is admitted by the SEC Chairman that investors are victimized by Delivery Failures. This should prompt an emergency response on the part of the SEC to stop this market activity by at least suspending the market maker exception, as millions of shares are failed to deliver every single trading day, until a formal rule removing that exemption is put in place.

Unintended Consequences of a Complex Regulatory Scheme

The SEC has created a very complex regulatory scheme that fails to protect investors adequately and creates many unintended consequences in the securities markets, leading to a less efficient and distorted market. Few markets in this country that are regulated by a federal or state agency have as complex a regulatory structure nor are riddled with exemptions and special treatment by the regulators, as the securities market is.

In reality, except for certain processes and technical issues, market basics are the same and very simple in every market. All federal and state laws enacted by lawmakers mandate the fair and equal treatment of all participants in the markets. This is very basic.

Unfortunately, the SEC has taken an approach of letting industry firms write its regulations for it or influence them to such an extent that industry firms now have a handsome trade advantage over regular investors. The acronyms used are for the benefit of "price discovery" and for "liquidity". Despite the fact by introducing fake or unregistered securities into a particular market equation for a security, price discovery becomes impossible and liquidity excessive. This leads to excessive volatile markets in the prices of securities and negative consequences for issuers. The SEC has permitted volatility, liquidity and price discovery to get distorted in this way, precisely due to delivery failures. The grandfather provision inserted without public debate into rule 203 by the SEC was explained by the SEC due to dears of excessive volatility if the delivery failures where forced to be closed out. So clearly the SEC does understand some of these concepts of the effects on volatility with the introduction or removal of delivery failures from a market.

Worse, by standing idly by as securities industry firms fail to deliver **unregistered securities** in unlimited amounts that they sell to investors, the SEC is permitting direct material harm not only to investors, but also to firms who issue and rely on the fair price discovery and price stability of their **registered securities** and the employees of those firms.

In a recent Bloomberg TV special, where the topic was investigating delivery failures, Sedona Corporation stated that due to the excessive selling of their securities made possible by delivery failures by industry firms – delivery failures which are documented - they have had to slow down product development and reduce their employee count from 70 to 15 because capital they planned on raising became impossible. However, industry firms must have made a ton a money naked shorting Sedona. The SEC's regulatory scheme benefits those it is charged with regulating and harms those it is charged with protecting – even innocent employees who do not invest in the securities markets.

Another consequence not already mentioned in other comment letters filed within the comment period, is the diminished legal recourse against issuers when unregistered securities are sold into the market :

One example is the case of Endocare Inc. (ENDO).

After some accounting shenanigans by the company, a shareholder suit was filed. A notice from the court of a proposed settlement was sent out to share holders. To one share holder, it indicated that based on the purchase dates, the share holder was eligible to receive about $6.04 per share from the settlement (less some expenses)

However, the estimates were based on authorized registered shares. The class attorneys and the court had no clue of about the unregistered securities sold to investors via delivery failures and that had hijacked the trade symbol of the registered security. The amount on the check received by this share holder after 1.5 years, was about $ .40 per share.

The company processing the claims replied that "you got a pro-rata share, there were so many claims filed."

The unintended consequences of permitting unregistered securities from flooding the market of a security are many fold and reach into voting irregularities in share holder votes, to share holder recourse against issuers. Not to speak of harm caused to employees, issuers and their customers and creditors.

All this is justified by the SEC in the concern to provide liquidity and price discovery for markets. The real market effects are excessive price volatility and real harm to certain investors, aside from the parties already mentioned, many of whom don't even have a finger in the securities market.

So How Many Delivery Failures Are There Really?

Unfortunately, this is impossible to know without full transparency on this issue by all brokers-dealers and clearing agents dealing and clearing in the U.S. registered securities. But with globalization of the securities industry, with more and more broker-dealers and clearing agents located outside this country that deal in the U.S. securities industry, this will never be fully known. Even the DTCC only has a small piece of the puzzle. It's like trying to determine what the global viral load of a world wide pathogen that causes sickness and disease is. Trends and general indicators are the best one can hope for.

The broadest set of numbers available in the U.S. are available from the SIA. Bellow are the liabilities of NYSE member firms for delivery failures in $ millions :

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
4,814.8	8,144.8	14,681.2	31,635.0	11,592.1	16,292.6	70,454.1	24,896.8	45,172.8	81,312.1	27,623.9

Though volatile, the sharp increase over the past 10 years in this data is clearly visible. By 2005, the NYSE member firms alone had an outstanding market to market liability of $27.623 Billion U.S. dollars for delivery failures and ostensibly for the sale of unregistered securities, as reported by the NYSE member firms to the SIA.

As recently as Q2 and Q3 of 2006, the NYSE member firms have further increased their delivery failure liabilities as seen bellow, in $ millions:

2006:Q2	2006:Q3
35,389.2	32,210.8

Taking in the entire universe of NASD broker-dealers and clearing agents and all world wide broker-dealers and clearing firms would reveal far larger numbers than from this limited sample. Unfortunately, that data is not available to me.

Suffice it to say, the problem is far beyond what the DTCC can even know, because only a small percentage of trades fail through the DTCC and makes a mockery of what the NASD wants the SEC and the public to believe.

It is easy to see that the market to market value of delivery failure liabilities is probably in the $100 Billion range – at least.

The above numbers are lifted directly from the spreadsheet provided by the SIA from their own website.

Solutions to the $100 Billion Problem

It is clear the problem of delivery failures is very large, in the magnitude of $100 Billion or more and only getting worse with the public and investor groups being harmed. Delivery failures are also only possible in tandem with the SEC not enforcing provisions of the 1933 and 1934 Securities Acts that strictly **prohibit the sale of unregistered securities** and by not treating all investors equal. The market maker exception permitting derivative market makers at the expense of equity investors are one such investor group that benefits handsomely.

It is also clear that delivery failures are in violation of the will and intent of congress for over 70 years.

The only solution that addresses all the problems mentioned in this letter is the simple removal of delivery failures and unregistered securities from the market by taking the simple and easy steps listed bellow, which would also greatly simplify the SEC's regulatory scheme:

1. Eliminate the Grandfather Provision in rule 203
2. Require delivery of the **registered security** or **trade cancellation** of long term delivery failures maintained under the Grandfather Provision
3. Eliminate the Market Maker Exemption in rule 203 completely
4. Require delivery of the **registered security** or **trade cancellation** of long term delivery failures maintained under the market maker exemption
5. Enforce the provision in the 1933 and 1934 Securities Acts that prohibit the sale of unregistered securities
6. Institute **Delivery Vs. Payment** system on all securities trades
7. Withhold all funds from sellers until delivery of the contracted **registered security**.
8. Ensure that the number of securities entitlements credited in investor accounts by broker-dealers are equal to the number of **registered securities** these broker-dealers have in a legitimate depository. Otherwise these securities entitlements convert to **unregistered securities**, which would negate all the above points and be in violation of the Securities Acts.
9. Provide for **mandatory cancellation** of all trades upon delivery failure (after T+3) of the **registered securitry**, lest these FTDs and FTRs become **unregistered securities** entering the market, which would negate all the above points and be in violation of the Securities Acts.
10. Provide for meaningful penalties for each delivery failure of registered securities.

Eventually, **unregistered securities** can be removed by the borrowing real **registered securities** from willing lenders and delivering those or by buying the required **registered securities** in the open market.

The current problem stem from the complex exemptions required to permit favoritism. Treating investors unequal in this manner discriminates against some and causes other unintended consequences that are far reaching.

It is a relief to say that the solution suggested above simplifies the complexity, treats all investors equally and realigns the SEC's regulatory scheme with that of the will of Congress, the Securities Acts and the SEC's own mandate.

Please fell free to contact me via email if I may be of further assistance in this matter to the Commission or if you wish for me to provide further information or data.

Sincerely,

Thomas Vallarino