



NIPC

National Investor Protection Coalition

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“Advocates for the Protection of Equity Securities Investors and Issuers”

Request for Rulemaking under the 1934 Securities Exchange Act to Adopt New Rule 15c3-4 to Address the Practice of Market Participants Redefining Securities in Customer Accounts Past T+3

April 03, 2008

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

RE: Petition for Rulemaking

Dear Ms. Morris:

NIPC is a non-profit advocate for the protection of equity securities investors who buy and hold equity securities through registered brokers, and the corporations who issue these securities.

This petition serves to address the very urgent matter of the harm done to our members and to equity security investors and issuers resulting from the informal adoption of the *de facto* SEC “rule” granting authority to registered market



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participants to **redefine** the “security” that is credited to a customer account past T+3, from the definition of “security” in federal securities laws, to “security” as defined in the state’s adopted UCC. NIPC’s position is that investors are receiving inferior and distinctly different securities past T+3, in an undisclosed manner and which are not defined in federal securities laws.

Federal securities laws and state jurisdiction issues preempt the definition of “security” as defined in the UCC, in customer accounts past T+3. Nevertheless, the SEC has clearly issued this authorization to market participants:

“...a securities broker-dealer may credit a customer’s account with a security even though that security has not yet been delivered to the broker-dealer’s account by NSCC. In that event, the customer receives what is defined under the Uniform Commercial Code as a “securities entitlement,”” (Emphasis added)

The result is that federal securities laws clearly say one thing, while the SEC informally authorizes market participants to do another. And this is not a “rule” that deviates slightly from published federal securities laws, rather it undercuts existing laws, going 180 degrees **in the opposite direction**. The “rule” is not only fatally flawed in structure, but since it was never put through the rigors required by the APA, the *de facto* “rule” is also fatally flawed in its adoption.

The *de facto* “rule” (the “**UCC rule**”), creates counterparty risks, pre-settlement risks, systemic risks, price erosion risk and other burdens and costs for equity security investors and issuers. It also eliminates some of the rights afforded investors and issuers under federal and state laws.

In addition, the redefinition of “security” misleads equity investors by crediting “securities entitlements” in an **undisclosed** manner to customer accounts past T+3, because the redefined “securities” or “securities entitlements”, are **misidentified** in customer accounts as being the contracted-for securities, when they are merely “securities entitlements” - and not the securities customer have contracted and paid for. Because of this, customers have an ever lower confidence level as to the assets held by market participants on their behalf, and of the fair functioning of the equity securities markets. Securities and assets held for customer past T+3, are questionable in quality and can be inferior to those customer have paid for. All this despite that redefining “security” per the UCC past T+3 is not defined in any federal securities laws, and is actually prohibited by federal and other state laws, for any reason.

There is precedent to the SEC attempting to redefine the clear text of federal laws. When the SEC failed to redefine the term “bank”, as defined in the Exchange Act, the D.C. Circuit Court found in *American Bankers Association v. SEC*, that: **“The SEC cannot use its definitional authority to expand its own jurisdiction and to invade the jurisdiction” of others**, particularly where the SEC’s interpretation is in direct conflict with the language of the Exchange Act.



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The SEC also failed in its attempt to redefine “Investment Advisor”. In that instance, the D.C. Circuit Court found in *FPA Vs. SEC*: “...*where the statutory text is clear, an agency may not use general clauses to redefine the jurisdictional boundaries set by the statute.*”

The authorization in the “UCC rule” exceeds the SEC’s statutory authority because it encroaches upon an area reserved for the states. The D.C. Circuit Court relied on this principle in *Business Roundtable Vs. SEC*, explaining that “*state corporate law . . . regulates the distribution of powers among the various players in the process of corporate governance,*” and that the Commission accordingly lacks statutory authority to “*leap beyond disclosure*”-as the UCC Rule engages in “*just that sort of regulation.*”

The *de facto* “UCC rule” gives market participants the cover they need to redefine securities in customer accounts past T+3 to lesser quality securities than customers paid for.

Purpose

Through this petition, NIPC seeks to ensure that customer securities accounts always accurately identify the correct type and number of equity securities that brokers obtain and maintain for customers past T+3, and to ensure that brokers do not dilute the rights that investor and issuers have under existing federal and state laws. The proposed rule also seeks to ensure that the securities obtained and maintained for customers past T+3 are always of an equivalent standard and quality for which customers have paid.

This should be easy to do since market participants already accurately account for the type and number of securities on their own books. The types of securities and financial assets on the books of market participants include FTRs, IOUs, securities entitlements and other assets held for customers. However, customer accounts never reflect the financial assets or mere promises/counter party risks, that are held for customers in lieu of the contracted for securities past T+3. We feel that if customer funds are being debited by market participants they should be able to use those funds to obtain and maintain securities of like type, quality and value after T+3, if not the exact securities contracted for. Mere promises and empty “securities entitlements” are not sufficient.

Given that the SEC and market participants have deeply ingrained redefining securities per the “UCC rule”, we believe that the best way to achieve this for all concerned is for the SEC to adopt a new formal rule to undo the ingrained nature of the “UCC rule”. To this end, we respectfully petition the SEC to adopt new rule 15c3-4 (the “**Customer Account Rule**”), per the public rule making process required by the APA, pursuant to the authority granted the SEC under Section 36 of the 1934 Securities Exchange Act.



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The proposed rule assures the integrity of customer accounts by requiring that:

1. All failed trades are broken at T+3 and all funds are re-credited to customer accounts immediately
2. Brokers must debit the securities they hypothecate from customer accounts and when excess margin securities are hypothecated - credit clearly marked replacement securities that comply with 3,4 and 5 below
3. Only NMS securities that fulfill the registration requirements of Section 5 of the securities act of 1933 can be credited as replacement securities to customer accounts when customer excess margin securities are hypothecated. Cash may be used as well
4. No replacement securities credited to customers when customer securities are hypothecated may be guaranteed or issued by market participants, nor have counterparty relationships created with them
5. The replacement securities must have an aggregate value equivalent to the value of the hypothecated customer securities
6. Customers become the beneficial owners of the securities provided in lieu of the hypothecated securities, and maintain full control over them including the ability to sell them at any time
7. Prescribes penalties to anyone violating the rule

Our request to the SEC is attached under exhibit "A". And the text of the proposed rule is attached under exhibit "B".

Background

Historical Perspective

Securities brokers have a long tradition of preying on investors. Kansas banking commissioner Dolley called many securities brokers "blue sky merchants", as many investors were victimized by the offering of securities backed by nothing but the "blue skies of Kansas." Kansas passed the first so called, "Blue Sky Laws" in 1911. It ordered that securities be registered and that brokers be licensed. Within two years twenty-three states had followed this lead and by 1933, all states except Nevada had adopted similar blue sky laws requiring the registration of securities and brokers.

Despite the effort led by the states beginning in 1911 in passing these blue sky laws, brokers easily found ways around them. The problem was so acute that the New York Stock Exchange adopted registration provisions. Unscrupulous dealers circumvented even these efforts by selling "unlisted" securities "over-the-counter" or on the "curb exchange", and by crossing state lines.

Following the 1929 market crash, the Senate Banking and Currency Committee called as its first witness in 1932, in hearings now referred to as the Pecora



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Hearings, the president of the New York Stock Exchange, Richard Whitney. He famously said to the Senators: "You gentlemen are making a great mistake. The Exchange is a perfect institution.". Obviously, the 72nd Congress, the 73rd Congress and President Franklin Delano Roosevelt took a different view, and passed the Securities Act of 1933, the Banking Act of 1933, and the Securities Exchange Act of 1934. *"It puts the burden of telling the whole truth on the seller,"* as President Franklin Delano Roosevelt commented.

From 1933 to about 1968 the settlement of securities transactions was accomplished through the physical delivery of stock certificates among brokers. Each broker had his own securities depository. It was customary for brokers to settle customer accounts only with registered securities, and only if brokers actually had them. This was (and still is) required by the Securities Acts, *because brokers are and were required to treat the person for whom the account is maintained as entitled to exercise the rights that comprised the security* - with "Security" as defined by the Securities Acts and SEC rules, not by UCC definition.

With the rising trade volume that began in the 1960s, the settlement system of physical delivery bogged down. With so many delivery people crisscrossing New York from one broker to another, delivering stock certificates to settle trades, brokers became inundated with paperwork. The brokers got so far behind in clearing and settlement paperwork that many trades needed to be marked with a "DK" notation, for "Don't Know". In addition, fails-to-deliver of securities between brokers spiked to \$4.1 Billion in value by the end of 1968. Due to the problems experienced in the paperwork and financial crisis of 1967-1970, 115 firms left the NYSE either by merger, resignation or liquidation.

A structural change began around 1968 when the NYSE started their Central Certificate Service, which eventually morphed into the DTC. It was the hope of the industry that this new approach would solve most of the problems created by unprecedented trading volume.

The Basic Solution to the Paperwork and Financial Crisis

1. Immobilize the securities in a central securities depository – now at the DTC
2. Clear trades via a central clearing agency – now mainly via the NSCC
3. Settle trades by moving securities only via book entry – Based on U.C.C. Section 8

The two main innovations are the **immobilization** of securities in a central securities depository ("CSD"), and the transfer and settlement of securities via **book entry movements**. The latter necessitated the amendment of the UCC, adding part 5 to Article 8, which all states adopted in 1994.

But securities are not transferred directly from the CSD to the customer accounts. Rather, the system in place requires at least two movements of the security for



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every one transaction contracted by the customers - and often more than two,

1. A movement from the CSD to the broker, and;
2. Another movement from the broker to the customer account.

The two securities movements via book entry are not connected in any physical or directly accountable way and there is no connection visible to investors. When removing securities from customer accounts, the process is reversed. Various scenarios require several book entry movements for every one trade, between various brokers and/or clearing agents before the final book entry movement to or from customers.

With this system, trade settlement, the integrity of customer accounts and the integrity of the entire market, **rests purely on the integrity of the book entry movements and the definition of “securities” in customer accounts.**

The SEC’s intent is clear

However, in adopting the *de facto* “UCC rule” the SEC authorizes the redefinition of securities in customer accounts after the settlement cycle by market participants, destabilizing the integrity of all securities markets, the confidence of investors and harming investors and issuers. The SEC tries to get around the fact that existing federal securities laws and state jurisdiction issues prohibit this, by relying on the state’s adopted UCC as an authority instead. One is left to ask, why? Fortunately, federal laws preempt state laws.

As recently as in the open market meeting on March 04, 2008 regarding proposed rule 10b-21 the SEC again voiced concern that market participants should continue to have the ability to naked short sell and be excluded from rule 10b and 10b-21 and that the fails that market participants create and pass on to others should be excluded from anti fraud rules. 10b-21 does nothing to reverse or limit naked short because it overlaps and restates what is already prohibited under federal laws. However, attempting to protect market participants from 10b, when market participants cause and pass on fails, shows the SEC’s long held intent and that it encourages market participants to cause and pass along delivery failures. Attempting to shield them from 10b merely confirms the “UCC rule”.

Public statement number 1

Because there are no federal laws defining securities past T+3 or that authorize delivery failures past T+3, the SEC instead relies on the state’s UCC in its adoption of the *de facto* “UCC rule”. The SEC describes the authorization granted brokers in an Amicus Brief submitted to the Nevada Supreme Court:



“The fact that a broker-dealer that is an NSCC member fails to receive securities that it purchased on behalf of a retail customer does not mean that the customer’s purchase is not completed until the member’s failure to receive is cured Under Article 8 of the Uniform Commercial Code, a securities broker-dealer may credit a customer’s account with a security even though that security has not yet been delivered to the broker-dealer’s account by NSCC. In that event, the customer receives what is defined under the Uniform Commercial Code as a “securities entitlement,” which requires the broker-dealer to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the security. See UCC Sections 8-104, 8-501.”(emphasis added)

Note: Broker-dealers only receive “failure to receive” notices past the settlement cycle.

The SEC is clearly stating here that they have granted broker-dealers authority to redefine “security” past T+3 in customer accounts, from the definition in federal securities laws, to the definition in the UCC adopted by the states - when brokers do not receive the contracted for securities within T+3. The SEC goes on to explain in the Amicus that registered market participants act only as authorized by the SEC, and are prohibited from acting in contravention of such authority. The intentions of the SEC are thus clear and because the SEC relies on the UCC’s definition of security, we have christened this informal authorization the “**UCC rule**”. The only problem in this is that the UCC is a state-adopted authority, and is thus preempted by federal laws.

Public statement number 2

In Securities Exchange Act Release No. 56213 (August 07, 2007) (“Amendments to REG SHO”), the SEC tries to explain the SEC authority under which brokers can redefine “security” past T+3 in a rather creative way, which they are forced to do since there are no federal laws that can be quoted. However, the intent and signal to market participants and everyone else is clear:

“..., where a seller of securities fails to deliver securities on trade settlement date the seller unilaterally converts a securities contract (which should settle within the standard 3-day settlement period) into an undated futures-type contract, to which the buyer may not have agreed”

The main problem here is that the above is not defined in federal securities laws anywhere – there is nothing in federal securities laws that is even close.



Public statement number 3

In Securities Exchange Act Release 56213, July 14, 2006, the SEC further states that **failing to deliver securities past T+3 does not violate the settlement cycle rule.**

That statement is a clear signal to ignore the settlement cycle rule, 15c6-1, at will. It also exempts the settlement cycle rule and completely changes the nature of the securities markets. But the statement in the release is not supported in any federal securities laws. The SEC does not offer any other justification for the statement. But the intent of the SEC and the message to market participants is clear. NIPC's issue with this is that effecting delivery failures (naked short selling), exempting the settlement cycle rule and redefining securities outside the settlement cycle are all not defined nor authorized in published federal securities laws.

Brokers and the SEC act as if the “UCC rule” had already been adopted

The prime brokers certainly already act as if the “UCC rule” was a formal rule. In a filing to California Supreme Court dated February 01, 2008, defendants MORGAN STANLEY, GOLDMAN SACHS, BEAR STEARNS, BANK OF AMERTCA, THE BANK OF NEW YORK, CITIGROUP, CREDIT SUISSE, DEUTSCHE BANK, LEHMAN BROTHERS and UBS SECURITIES, state:

“The SEC's scheme under Reg. SHO plainly allows for fails to occur. Even assuming fails create 'phantom shares,' Plaintiffs efforts to eliminate them conflict with the SEC's decision to permit fails.”

The brokers are clearly expressing the authorization the SEC has granted them to redefine “securities” to phantom shares. However, nowhere in federal securities laws are “phantom shares” defined. The same is true for an “*undated futures-type contract, to which the buyer may not have agreed*”. These types of securities in customer accounts after T+3 are simply not defined in federal securities laws.

However, the SEC has clearly effectively adopted the “UCC rule”, as the entire market operates as if that rule was adopted, creating an environment where there is a *de facto* adopted SEC “rule” that permits the redefinition of “security” past T+3 in customer accounts.

The SEC’s “UCC rule” is not defined in federal securities laws

Due to the conflict preemption doctrine contained in the U.S. Constitution, the “UCC rule” is preempted past T+3 because it conflicts with published federal securities laws. NIPC has searched in vain in the federal register for laws that either exempt the settlement cycle of T+3 or authorize effecting delivery failures past T+3.



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Equally absent are federal securities laws that authorize customer securities to be redefined past T+3 from the existing definition of “security” in federal securities laws. No such securities laws exist. And neither market participants nor the SEC have been able to cite any existing federal securities laws that authorize this behavior.

Some argue that REG SHO authorizes the “UCC Rule” and delivery failures. However, there is no such authorization in REG SHO. The rule only speaks to locate and close-out requirements and does **not** contain any authorization to effect naked short sales or to redefine securities past T+3 in customer accounts. Nor does any other federal law authorize “securities entitlements” past T+3 or exempt the settlement cycle.

In Securities Exchange Act Release No. 56213 (August 07, 2007) (“Amendments to REG SHO”) the SEC states that federal securities laws do not define the practice of selling short without having stock available for delivery, and intentionally failing to deliver stock within the standard three day settlement cycle.

“We have previously noted that abusive “naked” short selling, while not defined in the federal securities laws generally refers to selling short without having stock available for delivery and intentionally failing to deliver stock within the standard three day settlement cycle.” (emphasis added).

While it is true that abusive naked short selling is not defined by federal securities laws, it is also true that no type of naked short selling is defined by federal securities laws – not intentional, unintentional, abusive, accidental, or any other type of fails or for any reason. The same holds true for the securities that naked short selling produces after T+3 – UCC-defined “securities entitlements” which are not defined in federal securities laws in any way shape or form either.

If one ignores all the conflicts with existing federal securities laws, the state jurisdiction issues, and all legal precedents, the fact remains that the “UCC rule” was never adopted via a public rule making process, making the “UCC rule” not only fatally flawed in its construction, but also in its adoption.

Federal laws and by state jurisdiction that preempts the “UCC rule”

1. The “UCC rule” was never adopted via public rule making per the APA, thus invalidating it
2. Past T+3, the “UCC rule” is preempted, as federal securities laws do not define effecting delivery failures
3. “Security”, as defined in federal securities laws is incompatible with the



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UCC definition of “security”

4. Federal securities laws do not authorize securities to be redefined
5. Redefining securities to UCC defined securities from the plain text of existing federal laws that define security, encroaches on the jurisdiction reserved for the states, as decided by the U.S. Supreme Court and removes rights and protections afforded investors and issuers under state and federal laws.
6. The clearly expressed will of the U.S. Congress is ignored by the SEC in adopting the “UCC rule”. It harms and misleads investors and issuers, does nothing to increase capital formation, creates inaccurate account statements, de-links settlement from clearing, suspends the settlement cycle indefinitely, increases market speculation, substantially increases systemic risk and discriminates against customers to give an advantage to market participants.

Existing laws preempting the “UCC rule”

SEC rules

Rule 10b-3

Rule 10b-3 makes it unlawful for brokers to violate any SEC rule or any other securities law, especially when done to deceive or manipulate customers. Brokers practicing the “UCC Rule” past T+3 are acting in an unlawful manner when they violate the rules and laws listed below. Redefining securities in customer accounts past T+3 is not defined in federal securities laws, nor is failing to deliver securities past T+3, for any reason.

Rule 10b-10 (Confirmation)

This rule requires brokers to disclose to customers **the identity of securities purchased**. It does not permit the misidentification of securities. For example, if 100 OSTK shares are identified as purchased in the trade confirmation to a customer at the end of a purchase transaction, then the customer should be able to look up the registration statement of OSTK securities and fully expect that these are the exact securities held on his behalf, conferring him with the rights that these securities carry....and not instead redefined securities pursuant to the UCC, with a market participant as a counter party or issuer.

The UCC-defined securities don’t have a registration statement and if they did, the registration statement would be materially different from the registration statement of OSTK securities. No matter how one looks at it, the two securities are different, and misidentifying the securities misleads investors.

By authorizing brokers to misidentify the type of securities in customer accounts and in customer trade confirmations, the “UCC Rule” conflicts with rule 10b-10, since 10b-10 requires brokers identify, not misidentify, the securities settled to customers. Deliberately misidentifying the type of securities settled to customers at the end of the settlement cycle misleads investors.



Due to the conflict preemption doctrine, the “UCC rule” is preempted by all rules and laws which prohibit misleading customers.

Rule 12B and Regulation C

For the most part, redefined securities that are credited to customer accounts past T+3 when applying the “UCC rule” are guaranteed or issued by FINRA members, but usually by the broker. And they are issued and sold in such a way that for the most part Section 5 of the Securities act of 1933 applies to them, and requires these securities have a valid registration statement filed with the SEC, and comply with Rule 12B and Reg C. However, these rules and laws are ignored under the “UCC rule” in violation of these two rules, as well as 10b-3 and 10b-5.

Rule 15c6-1 (Settlement Cycle)

This rule prohibits a broker, that is contracted to purchase specific securities for a customer, from delivering the contracted securities later than the third business day after the date of the contract, unless, **at the time of the transaction**, both parties expressly agree otherwise. Since most customers contract their brokers to purchase securities without any such agreement to extend the delivery past 3 days, brokers are for the most part prohibited from delaying delivery of the contracted-for securities by this rule.

The “UCC Rule” is in conflict with 15c6-1 as it authorizes brokers to ignore the settlement cycle. Brokers routinely deliver the contracted-for securities well past the 3rd day to customer accounts by relying upon the “UCC Rule”. Sometimes the delivery period to customers stretches out for months or years, with customer accounts credited with redefined securities per the UCC.

15c6-1 was adopted exactly to avoid the problems that the “UCC Rule” causes. Violating 15c6-1 also violates 10b-3 and 10b-5.

Conflicts with FINRA rules

2340. Customer Account Statements

Except as otherwise provided by paragraph (b), each general securities member shall, with a frequency of not less than once every calendar quarter, send a statement of account ("account statement") containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer.

If some securities in customer accounts are really not those defined in federal securities laws, but rather UCC defined securities, then the account statements should say so and accurately describe them as such, according to this rule. The “UCC rule” adopted by the SEC and on which FINRA members are acting is in violation of this basic rule.

IM-2310-2. Fair Dealing with Customers

Misrepresenting customer accounts, crediting redefined “securities” that are not defined in federal securities laws to customer accounts, misrepresenting customer voting rights and redistributing them instead, cannot be considered fair dealing with customers.

2330. Customers' Securities or Funds

(e) No member or person associated with a member shall guarantee a customer against loss in connection with any securities transaction or in any securities account of such customer.

When trades fail to settle on T+3 and the trade is not broken, the securities credited in customer accounts are often guaranteed by FINRA members because FINRA members issue “securities entitlements”. In these cases FINRA members are guaranteeing the “securities entitlements” until the contracted-for securities are delivered or received in enough quantities to satisfy delivery to customer accounts. The same is true when securities are hypothecated from customer accounts using the “UCC rule”. FINRA members are thus guaranteeing the value of some securities in customer accounts during this period, in violation of the rule.

Conflicts with CBOE rules

Rule 4.7. (Manipulation)

(a) No member shall effect or induce the purchase, sale or exercise of any security for the purpose of creating or inducing a false, misleading, or artificial appearance of activity in such security or in the underlying security, or for the purpose of unduly or improperly influencing the market price of such security or of the underlying security or for the purpose of making a price which does not reflect the true state of the market in such security or in the underlying security.

The clear text of the rule speaks for itself. What is important to note is that “security” includes equity security, not just derivative contracts.

Conflicts with federal statutes

Section 5 of the Securities Act of 1933

This section defines "securities" and maintains the integrity of customer accounts and the markets. It makes it unlawful for most securities to be sold and transferred unless there is a valid registration statement describing the security on file with the SEC. The securities described in the registration statement are then given a CUSIP number and a trade symbol. The information comprising the security is disclosed to investors in this fashion.

The “UCC Rule” conflicts with this most fundamental law, because the “UCC



Rule” authorizes brokers to credit redefined securities to customer accounts that do not match the disclosures contained in the registration statements. This redefinition of securities produces unregistered securities in customer accounts. The crediting of unregistered securities in customer accounts outside T+3 is in violation of this most basic market law, which describes and discloses the securities bought and sold.

Section 17 of the Securities Act of 1933

It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act [15 USCS § 78c note]) by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly--

1. *to employ any device, scheme, or artifice to defraud, or*
2. *to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or*
3. *to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. (emphasis added)*

The “UCC Rule” authorizes brokers to deliberately misidentify securities in customer accounts past T+3. Brokers are not only making untrue statements on the trade confirmations after T+3, but they are also obtaining money owned by customers by employing these untrue and misleading statements, which omit the true nature of the securities credited to customer accounts after T+3. This is a deception upon the purchaser, and the authority in the “UCC Rule” conflicts with several provisions of this section.

Section 6(b)(5) of the Securities Exchange Act of 1934

The intent of the U.S. Congress is clear:

The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange. (Emphasis added)



The “UCC rule” clearly discriminates against equity security investors and issuers and harms them in favor of market participants.

Section 9 of the 1934 Securities Exchange Act

This section makes it unlawful to create a false or misleading appearance of active trading in any security registered on a national securities exchange, or to create a false or misleading appearance with respect to the market for any such security, and to effect any transaction in a registered security which involves no change in the beneficial ownership. False and misleading statements are also unlawful under this Section.

Since the “UCC Rule” authorizes brokers to credit securities as defined by the UCC outside the settlement cycle when failing to deliver securities, the actual registered security experiences no change in beneficial ownership. This creates the false appearance of active trading and produces the false appearance of market activity in the registered security. This is really market activity in the unregistered security being misreported as market activity in the registered security.

Therefore, the “UCC Rule” clearly conflicts with Section 9 of the 1934 Securities Exchange Act.

Section 10 of the 1934 Securities Exchange Act

This section prohibits brokers to act in contravention of SEC rules and securities laws, and prohibits the use of any deceptive devices in the selling of securities. Since many aspects of the “UCC Rule” conflict with SEC rules and securities laws, the “UCC Rule” is in conflict with Section 10 as well. Section 10 makes the practices sanctioned by the “UCC Rule” unlawful.

Section 12 of the 1934 Securities Exchange Act

“It shall be unlawful for any member, broker, or dealer to effect any transaction in any security (other than an exempted security) on a national securities exchange unless a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations there under.”

Those securities that are required to file a registration statement under Section 5 of the Securities Act of 1933 are required to do so pursuant to Section 12 of the 1934 Securities Exchange Act.

Here, the will of Congress for clarity is evident. Since the “UCC Rule” authorizes the crediting of securities that do not have a registration statement past T+3, the “UCC Rule” is in conflict with Section 12 of the 1934 Securities Exchange Act.



Section 17a of the 1934 Securities Exchange Act

The Congress finds that,

The linking of all clearance and settlement facilities and the development of uniform standards and procedures for clearance and settlement will reduce unnecessary costs and increase the protection of investors and persons facilitating transactions by and acting on behalf of investors.

The Commission is directed, therefore, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents, to use its authority under this title—

- i. to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities*

The authority under the “UCC Rule” is against almost every Congressional finding and direction the SEC has been given, and so conflicts with this section.

The “UCC Rule” de-links settlement and clearance facilities and hinders the prompt and accurate clearance and settlement of securities transactions.

The Settlement Cycle Rule 15c6-1 preempts the “UCC rule”

The settlement cycle rule plays a key role in regulating the securities markets. Improperly exempting the settlement cycle rule for brokers, without a public rule to that effect, creates a catastrophic problem for the US financial markets.

In 1993, the Federal Reserve Board noted that settlement systems for securities were a potential source of “systemic disturbance” to financial markets and the economy. In the Board’s view, the ideal scenario was settlement immediately after execution and payment in same-day funds. The longer the period from trade execution to settlement, the greater the risk that one of the parties may default on the trade. In addition, the larger the number of unsettled trades, the greater the opportunity for prices of the securities to move away from the contract price – thereby increasing the risk that non-defaulting parties will incur a loss when replacing unsettled contracts. The shorter the settlement cycle, the less pre-settlement risk exposure is assumed.

It was this type of concern, propelled by the 1987 market crash and the 1990 bankruptcy of Drexel Burnham, that caused the SEC to adopt **rule 15c6-1**, shortening the settlement time frame from T+5 to T+3, in 1990.

NIPC fully agrees with the SEC’s goal of keeping the settlement cycle as short as possible, with an eventual goal of T+0, and supports its adoption of rule 15c6-1.



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NIPC also applauds the manner in which this rule was publicly promulgated and adopted. It is the way it should be. We also recognize that the benefits outweigh the costs for investors, when for the sake of efficient markets, investors willingly take on some pre-settlement risk and price erosion of equity securities through the introduction of UCC “securities entitlements” to customer accounts and the market. It’s a cost of doing business that NIPC members are willing to accept. **But only for three days** – the duration of the settlement cycle.

Since rule 156c-1 limits the settlement cycle to three days, the use of UCC defined “securities” credited to customer accounts is limited to three days as well. 15c6-1 makes regulatory room for brokers to use the UCC and “UCC Defined Securities” to be applied when moving securities via book entry form within the settlement cycle. However, **outside** the settlement cycle, only securities defined per federal securities laws are permitted to be credited to customer accounts.

To be clear, this petition only covers the period after the settlement cycle ends, as 15c6-1 does permit the use of “UCC Defined Securities” and “securities entitlements” during the settlement cycle. However, outside of the settlement cycle, due to the doctrine of conflict preemption, federal securities laws preempt brokers from using the state level UCC as an authority to redefining “securities” in customer accounts to UCC defined “securities.”

The “UCC Rule” also causes conflicts with rule 10b-10, the trade confirmation rule, that requires that the securities being settled to customers are **identified**, not misidentified. Additionally, if the trade confirmations misidentify the securities settled as securities defined by the securities laws when in fact they are “UCC Defined Securities”, then customers are deliberately being misled by brokers, putting brokers in violation of SEC rule 10b-3 and 10b-5, among others. These other preemptive and conflicting laws will be listed in another section.

Conflicts with State Jurisdiction

The aforementioned conflicts and preemptions notwithstanding, the interference with internal corporate governance authority reserved for the states is reason alone why the “UCC Rule” is preempted past T+3, and needs to be replaced by a public rule. In the absence of express Congressional authorization, the SEC lacks statutory authorization to regulate corporate governance. The SEC is limited to regulating the proxy process and a few other aspects authorized by the Sarbanes-Oxley Act.

Lower courts and the U.S. Supreme Court have all repeatedly ruled that corporate governance issues are reserved for the states. As the US Supreme Court observed:

"Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law



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expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."

Section 14(a) of the Exchange Act makes it "unlawful for any person, . . . in contravention of such rules and regulations as the Commission may prescribe . . . ,to solicit . . . any proxy" Thus, as the Supreme Court has explained, Section 14(a) "**authorizes the [SEC] to adopt rules for the solicitation of proxies, and prohibits their violation.**" Section 14(a) expressly limits the Commission's rulemaking authority to the proxy solicitation process. As such, it limits the Commission's authority to regulating the **disclosures** made, and the procedures followed, in connection with proxy solicitations. Neither Section 14(a) nor any other provision in the Securities Acts authorizes the SEC to regulate the internal affairs of corporations.

The D.C. Circuit Court relied on this principle in *Business Roundtable Vs. SEC*, explaining that "**state corporate law . . . regulates the distribution of powers among the various players in the process of corporate governance,**" and that the Commission accordingly **lacks** statutory authority to "**leap beyond disclosure**"-as the UCC Rule engages in "**just that sort of regulation.**"

The "UCC Rule" expands the SEC's jurisdiction by authorizing brokers to interfere in internal corporate governance affairs by crediting securities to customer accounts past T+3 that do not have voting rights, without investors necessarily agreeing to give up their voting rights and in most cases not even knowing they no longer have voting rights. Voting rules and voting allocations set by corporations and states are an important method of governing internal corporate affairs with which the "UCC Rule" interferes. This authorization far exceeds the SEC's statutory limits and far exceeds regulating the proxy process.

Neither "*Unilateral-Undated-Not-Agreed-to-Futures-Type-Contracts*" nor "securities entitlements" have voting rights attached to them. Since these non-voting securities are credited to customer accounts in place of registered securities with voting rights, then investors do not have the voting rights they think they have, and which are being represented to them by their brokers. Corporations and states also lose their ability to allocate voting rights in this way.

An example of what can happen due to this practice, is when a non-investor party gains control of a corporation, without buying a single registered share, by simply borrowing the securities with voting rights that brokers have hypothecated from equity security investors. Vote outcomes may then not necessarily reflect the wishes of the investors in the corporation. The Wall Street Journal raised these corporate governance concerns in a lead story on January 26, 2007 headlined "How borrowed shares swing company votes".

The Securities Transfer Association, a trade group for stock transfer agents, reviewed 341 shareholder votes in corporate contests in 2005. It found evidence of



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over voting, the submission of too many ballots, in all 341 cases.

Thomas Montrone, chief executive officer of Registrar & Transfer, which oversees shareholder elections, describes the situation: "A lot of the time we have no idea who's entitled to vote and who isn't. It's nothing short of criminal."

In hypothecation or securities lending, the agreements that customers sign when opening a margin account, which seeks permission from customers to hypothecate their securities, does not preempt any securities laws or relieve brokers from complying with all of them. This includes those laws covering corporate governance issues.

In 1988, when the SEC indirectly tried to regulate voting rights by changing the listing standards, the SEC rule was vacated by the courts on the grounds that the SEC lacked authority to regulate in an area reserved for the states.

As the D.C. Circuit Court noted in analogous circumstances, "[with its step beyond control of voting procedure and into the distribution of voting power], the Commission would assume an authority that the Exchange Act's proponents disclaimed any intent to grant."

Any new rule that replaces the "UCC Rule" must take corporate governance issues into account. All securities credited to investor accounts past T+3 must have voting rights as determined by the corporations, not as determined by the SEC, SROs or brokers. Customer accounts must at all times accurately reflect the voting shares held on behalf of the customer by the broker past T+3 and not be misrepresented in this regard.

Another example of the interference that the "UCC Rule" has in corporate governance issues and the ability of the states to regulate this area, is when equity security investors are unable to obtain stock certificates for the shares they bought through their brokers, for months, or years on end. The CMKX and Nutek cases illustrate how the "UCC rule" conflicts with Nevada Revised Statutes Section 78.235. That law states that unless the articles of incorporation or bylaws of a corporation state to the contrary, a stockholder is always entitled to obtain a stock certificate from a Nevada issuer certifying the shares it owns.

Yet shareholders in CMKX and Nutek were not all able to receive the stock certificates that state law entitles them to, as neither "securities entitlements" nor *Unilateral-Undated-not-agreed-to-futures-type-contracts* nor phantom shares are entitled to stock certificates. Some equity securities investors will forever be frustrated and denied their right to receive certificates for this reason.

The only way to ensure that all investors can obtain stock certificates on demand is for the number of registered securities in customer accounts past T+3 to never exceed those issued and outstanding.



Conflicts With the APA

The APA mandates the SEC to make rules per a public rule making process:

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose.

The SEC's adoption of the *de facto* "UCC Rule" has ignored all the provision of the APA. The public and equity securities investors were never given an opportunity to participate in the rule making of the "UCC Rule" nor in the exemptions to the settlement cycle and other securities laws with which this practice conflicts.

This behind-closed-doors adoption is sadly consistent with the nature of the "rule", in that it keeps equity security investors in the dark as to the types of securities in their accounts. It is as if the goal of the rule is to keep this practice hidden, not only by failing to adopt it via public rule making, but by altering and exempting from federal law the types of securities misidentified in customer accounts. Equity securities investors and issuers have a right to know the purpose of this "rule", as it severely harms them financially.

Securities are redefined, making hypothecating securities more profitable

Although the practice of hypothecating customer securities by brokers is expressly permitted under rules 8c-1, 15c2-1 and 15c3-3, none of these rules, nor any other federal securities laws, authorize the redefinition of securities in customer accounts outside the settlement cycle. While the settlement cycle rule **does** authorize the redefinition of securities in customer accounts **within** the settlement cycle, **outside** the settlement cycle, this is unlawful.

The "UCC rule" authorizes brokers to misrepresent customer accounts when customer securities are hypothecated in a manner identical to the misrepresentation that occurs when securities are not delivered within the settlement cycle on purchase transactions.

This is because in the hypothecation process, brokers rely on the "UCC rule" to credit "*unilateral-Undated-not-agreed-to-futures-type-contracts*" or securities entitlements to customer accounts when the contracted for securities are removed from customer accounts outside T+3. These securities are not only redefined pursuant to the UCC but are misrepresented to customer accounts as being the contracted-for and federally defined securities, when they are not. Not only are they not the same, but customers are deliberately misled by false representations on the part of market participants.



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This misrepresentation allows brokers to do with customer securities what they used to do with customers free credit balances. As in 1969 when \$2 Billion in free credit balances of customers were used by brokers-dealer to fund their operations. Merrill Lynch had over \$300 million in customers' free credit balances in 1970. Earnings from customers' free credit balances accounted for 50% of Merrill Lynch's income that year. In spirit, 15c3-3 is being violated, but with customer securities rather than with customer cash.

The agreement that customers sign when opening a margin account, giving brokers permission to hypothecate securities from customer accounts, does not preempt any securities laws. When brokers actually hypothecate customer securities, they must do this in a manner that remains in full compliance with all federal and state securities laws. Unfortunately, brokers have incorporated the practice of redefining securities per the UCC authorized by the "UCC Rule" into the hypothecation process. This puts the hypothecation process as practiced in direct conflict with published securities laws.

When securities are hypothecated per the "UCC rule", equity securities investors and issuers are harmed by:

1. Losing the rights their paid for securities confer to investors
2. Loss in potential lending fees earned in the securities lending market
3. Price erosion of the equity securities hypothecated by brokers, as these are lent to short sellers who sell short the securities hypothecated, harming the price of customer assets
4. Undisclosed counterparty risks with market participants

There is a strong incentive for brokers to continue this practice because the securities lending industry earns about \$ 10 Billion in lending fees per year. And most of these fees are earned by brokers who have hypothecated securities from customer accounts for cheap. This is risk-free income earned by brokers, and the brokers do not want to lose this golden goose. They are thus motivated to keep the owners of those securities in the dark as to what the brokers are doing with their equity securities and the fees they are earning. What easier way to keep customers in the dark than by using the "UCC rule" to misrepresent the type and number of securities in customer accounts and to keep customers from knowing about the potential money to be earned with their property?

Some equity securities investors would no doubt ask for a piece of the lending fee pie if they were reminded every day by looking at their accounts that their securities were being hypothecated. Others would surely seek ways to stop and restrict the lending of their shares to minimize the effect of price erosion when short sellers sell short their borrowed securities. Short selling would surely become more expensive and less pervasive than it is today. By misleading customers into a lull, market participants make securities lending and short selling very profitable for them selves at the expense of equity securities investors.



The current hypothecation practice is akin to a real estate agent renting out a client's house, keeping the rent collected, and lying to the owner that the house is not rented. It is similar to when customer free credit balances were used by brokers to make up a major part of their operating income. One can see why brokers want to keep equity securities investors in the dark by misrepresenting the type and number of securities in accounts, and why the NIPC will fight to ensure equity securities investors receive full disclosure and accurate account statements, so that they can take appropriate steps to maximize the return on their investments, protect themselves from harm, and assert the full rights granted them under federal and state laws.

When customer securities are redefined past T+3 either in failed trades or when securities are hypothecated, investors and issuers are harmed. While there are cases where trades involving delivery failures are broken and where securities are not redefined in the hypothecation process, these instances are far too rare. To a large extent, securities are redefined past T+3 when trades fail and securities are hypothecated because it is more profitable for market participants that way. We remind the SEC of Section 6(b)(5) of the Securities Exchange Act that prohibits the discrimination in favor of market participants.

Systemic Risks

The "UCC rule" runs counter to the will of Congress and counter to the intentions of the states when they adopted the UCC rule and its amendments. For one, when the SEC was created, reducing systemic risks and market speculation was seen as an important goal. However, the "UCC rule" produces the exact opposite effect by authorizing the redefinition of "securities" and introducing another layer of counterparty risk than would not otherwise exist. The "UCC rule" also goes counter many corporate governance laws and state securities laws, that the states never showed an inclination to have cancelled through the application of the UCC as practiced and informally adopted by the SEC in the "UCC rule".

However, the effect of the SEC's "UCC rule" speaks for itself: Data from a Freedom of Information Act (FOIA) request for the total number of failed deliveries on the NYSE on May 31, 2006, shows that there were 65 million shares of failed deliveries in NYSE issues, and there were 590 total issues on the Reg SHO threshold list. For all markets and exchanges, between 700 Million and 1.5 Billion (known via in-clearing data from the DTCC, obtained through Freedom of Information Act requests) undelivered equity securities are outstanding on any given day in the U.S. equities markets, not including "ex-clearing" failures.

The FOIA data shows that NYSE and NASDAQ outstanding delivery failures (FTDs) represent 4% of average daily trade volume; and OTC outstanding delivery failures represent 28% of average daily trade volume. These figures are only for failed security deliveries over and above those concealed from view due to CNS netting effects, and do not include "ex-clearing" delivery failures.



Market participant obligations and counter party risks

One legitimate example, where systemic cracks can be torn open is when investors call on the counter party obligations market participants have when issuing or guaranteeing “securities entitlements” to customers. A very simple way this can happen is when the payment obligations that market participants have are called on.

More specifically, since market participants credit more securities to customer accounts than issuers have issued, market participants have a potential obligation to pay more in dividends to customers than the issuers do. The systemic risk sets in when market participants find no exit from their payment obligations to customers that “securities entitlements” create because customers refuse, in aggregate, to sell back the “securities entitlements” to market participants, while at the same time the issuer pays out dividends on its securities. If this goes on long enough, the entire system will collapse as there will not be enough money to pay the dividend obligations on the “securities entitlements”.

If for instance, investors buy a total of 1 million real and 1 million redefined “securities” from brokers when the company only has 1 million shares outstanding, the company is only obligated to pay dividends on the 1 million shares while brokers are obligated to pay the dividends out via PIL on the other 1 million “securities entitlements” they have issued or are guaranteeing. For every \$1 dollar that the company pays out, investors, in aggregate, receive \$2. The extra \$1 has to be paid by market participants to investors.

Similarly, if a tender offer is made for a security that has a high number of “securities entitlements” in customer accounts, at a price substantially higher than what customers paid, market participants will be obligated to make the payment to customers. If the loss to market participants is high enough, they will have to be liquidated.

The recent collapse of Bear Stearns, which could not meet its counterparty obligations and with a situation where nobody would take Bear Stearns as a counter party anymore, illustrates the dangers when market participants take on counter party risks and what can happen when they can’t make good on their obligations anymore. Yanking the thread of the securities entitlement obligations that are outstanding and forcing them to pay PIL and reinvesting that PIL in an upward self propelling spiral, is a house of cards that can fall and that customers and tax payers would be asked to pay. Again, we have to ask for what purpose the SEC allows this type of risk to be taken on only to give an advantage to certain market participants over other investors while hoping that nobody notices the risk or how to take advantage if it.

Bear Raids

While the SEC has been very keen on avoiding “pump and dump” schemes and issuer fraud, the SEC has sadly stated that redefining securities and ignoring the settlement cycle rule is one way to combat fraud. Securities Exchange Act release



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No. 50103 (REG SHO final Rule, 2004):

“It is the Commission's belief that removing all restrictions on the ability to effect naked short sales is not the proper recourse against potential issuer fraud, as it may simply encourage another type of manipulation...”

This statement is made despite the fact that the final published REG SHO rule does not offer even limited authority to effect naked short sales or redefine securities past T+3 for anyone, for any reason. Thus nothing can be removed if it isn't there in the first place.

That small detail aside, the statement does show the intent of the SEC and the logic that perhaps two wrongs make a right. Unfortunately, two wrongs are worse than one wrong. Authorizing market participants to naked short sell and redefine securities past T+3 does nothing but harm equity investors and issuers even more by making bear raids extremely effective.

Not only do bear raids destroy capital and harm equity investors and issuers by limiting their access to the equity capital markets, but bear raids endanger the entire economic structure of the USA. A sampling of how easy and damaging bear raids can be through naked short selling and the resulting “securities entitlements” is well documented in the lawsuits filed by [Fairfax Holdings](#) (FFH) and [Overstock.com](#) (OSTK) and others. Basically, the “UCC rule” allows the creation of unlimited downside sell liquidity, making the destruction of companies profitable to those who can take advantage of the “UCC rule”.

Domino Effect

Bear raids in equity securities do not just cause isolated problems with issuers but they can cause counter party defaults that spread to others areas and can cause a systemic wide problem in a domino effect. For instance, if the mono line insurers like AMBAC and MBIA which have \$2.4 trillion in guarantees outstanding for municipal bonds and mortgage-related structured investments, can not access the markets to recapitalize and keep their high investment grade credit ratings, then the insured paper would become junk debt and cause problems for those institutions that hold them, necessitating an instant mark down and further liquidity and asset valuation problems in a magnitude measured in the Trillions. The “UCC rule”, by causing harm to equity investors and issuers makes this melt down scenario more probable – and is completely unnecessary, not to mention unlawful.

The inferior value of “security entitlements”

From Gary Aguirre's recent memo to the Senate banking committee:

“The investment banks and hedge funds have come up with a new principle for protecting the capital markets. It is called counterparty discipline. Translated, it means: “Trust us.” The



term is tossed around as if it were natural law in the financial markets, much like gravity in the physical world. In reality, counterparty discipline is a slogan, a myth, which has been sold to regulators by investment banks and hedge funds so they can operate in the shadows without regulation."

We agree for the most part with this assessment in that market participants introduce "securities entitlements" of lesser quality into the market where securities of a higher quality should be and that customers have paid for. Instead market participants issue or guarantee "securities entitlements" past T+3 of questionable quality and value while obligating customers into a "trust us" counter party risk, while customers are misled that they are receiving the higher quality securities they paid for. In any case, these UCC securities are not defined by federal securities laws and we feel are mostly of inferior quality.

Market participants can thus gain access to customer assets and securities for their own gain at the expense of everyone else. One has to ask why, in light of section 6(b)(5) of the Securities Exchange Act and all the counter party and systemic risks that are created, the SEC is actively authorizing the "UCC rule", when otherwise no other goals of the SEC are met and is in direct conflict with existing securities laws.

Investors should not be obligated to take on undisclosed counter party risk

We do not feel that equity investors or issuers should be subject to undisclosed risks that have been outlined here. Customer assets should always be of the type and quality that customer have paid for. By introducing inferior "securities entitlements" with questionable value and more counter party risk, investor assets are saddled with risk that they have not bargained for.

Issuers also should be able to access capital markets freely without naked short selling and "securities entitlements" diminishing the ability of issuers to actually do so. If issuers suffer, so do the investors in the security issues. We think that natural supply and demand should determine the value of the securities of issuers and not the natural supply and demand + inferior and undisclosed securities being added to the supply side without limit. For even if one takes as gospel that market participants are authorized to naked short sell and redefine securities past T+3, there is nothing, not even in the informal "UCC rule" that puts a limit on the practice, which shows how irresponsible the "UCC rule" is, as it adds even more sell side liquidity in the form of "securities entitlements".

The SEC's contention that sell side liquidity should be available without limit so long as a market participants "need" to do so or really didn't intend to fail to deliver past T+3 or when market makers need to do so to make "reasonable" markets or when they don't make a representation on intent or ability to deliver - determined by the market participants themselves - we feel is dangerous and unnecessary, not to speak of being unlawful and discriminative against investors and issuers. It puts investors and issuers in harms way, for reasons that can only be seen as giving market participants advantages over others. In any case, customer assets should not

be transferred to market participants without disclosure and in conflict with many laws, just to give market participants a source of income.

FED action shows SEC's failure to recognize systemic risks

The oversight failure of the SEC is evident in the fact that the FED has now stepped in to allowed market participants to access emergency cash "loans" to the tune of at least 29 billion dollars, guaranteed by the U.S. tax payer. It is clear that the SEC failed to see the systemic risks being created over a long period of time.

Likewise, we feel the SEC is failing to see the systemic risks being created by authorizing market participants to effect delivery failures and to redefine securities past T+3. We believe the data shows that the SEC's concern with the need for market makers to naked short sell in order to "make" markets, is not justified and is actually less efficient.

The data provided by Erik Sirri, Director, Division of Trading and Markets U.S. Securities and Exchange Commission, in a speech on February 01, 2008, clearly shows this:

"The most noticeable shift in trading volume during this period is the decline in the NYSE's share of volume in its listed stocks from 78% in 2004 to 41% last month. Other quoting venues, however, have captured this large share of volume. (In January 2008), these other quoting venues, particularly Nasdaq, NYSE Arca, BATS ECN and Direct Edge ECN, executed more than 40% of volume in NYSE stocks."

"Elkins/McSherry has reported that, for the year ending June 2007, total transaction costs for institutional investors in NYSE-listed stocks fell by 15% from the previous year. Similarly, ITG's study of institutional trading costs for the 2nd quarter of 2007 found that institutional transaction costs in U.S.-listed equities had declined by 35% since the first quarter of 2005. Reduced commissions, lower price impact of large orders, and more timely execution of large orders all contributed to this improvement in the efficiency of institutional trading."

The studies suggest that there is no necessary correlation between the average trade size in the public markets and the efficiency of trading for institutional investors. Rather, the use of algorithms and other sophisticated trading strategies that search out the most efficient venues for executing different types of orders has enabled large investors not merely to deal with highly active, automated markets, but to benefit from them. Some of these venues, of course,

are dark ATSS, particularly those block crossing systems that have found creative ways for "natural" buyers and sellers in size to find each other, while still preventing information leakage prior to actually executing the large trade. In this respect, technology has found more efficient ways to deal with the perennial trading dilemma of finding a way to trade in large size without tipping the market.”(emphasis added)

If this data is correct, it shows that it is cheaper and more efficient to use automated markets that find “natural” buyers and sellers. It also shows that these types of trading venues are gaining ground precisely because they are better. If all this is true and ignoring the systemic risks created, one has to ask what the reason is for the SEC even wanting market makers to naked short sell, as it make for a less efficient market.

Speculation and excess liquidity are not necessary

The SEC oft repeats that short and naked short sales create liquidity needed in the securities markets. Yet there is not seen a single piece of empirical evidences that shows that this is true, nor that increased liquidity helps in the formation of capital, or any other goal stated in the Securities Acts.

The opposite is true. As an example, we can examine the publicly traded securities of one of the best performing securities on the planet in regards to liquidity:

Berkshire Hathaway - BRK.A and BRK.B

Both are highly illiquid with very low trading volume and no options trading on the equity securities. And that’s the way Warren Buffet likes it as he stays away from anything that might increase liquidity and volatility in the equity security, like stock splits.

Based on the BRK.A and BRK.B examination, it is undeniable that low liquidity actually helps the formation of capital. In no way does it harm the formation of capital. And this is no fluke, as Berkshire shares have been trading on the NYSE for over 30 years.

We ask the SEC to rethink its stance that liquidity is good for the protection of investors, issuers and is necessary for the formation of capital, as the evidence indicates that it only harms these constituents.

Investor and Issuer Confidence in US Markets Eroding

The Committee on Capital Markets Regulation, in a recent report released as a sequel to a report late in 2006, took 13 measures of competitive vitality and found American public equity markets were anemic in 12, and only trading water in one.

The committee found that, in the first 10 months of 2007, a record 56 foreign companies delisted from U.S. exchanges, compared to 12 a decade ago, and 30 in 2006. Only one of the 20 largest global initial public offerings in 2006 was listed on a U.S. exchange, and none was in the first 10 months of 2007, compared with eight of 20 in 1996.

The most telling indicator that U.S. equity markets are hobbled is the small but growing movement of American companies into foreign exchanges. From 1996 to 2005, it was nearly unheard of for an American company to list an IPO exclusively on a foreign exchange but, measured by value, 1.1 percent of American IPOs in 2006 were listed only on foreign exchanges. That jumped to 4.3 percent through Sept. 30, 2007.

Hal Scott, Nomura Professor and Director of International Financial Systems at Harvard Law School, who founded the committee, said "It is a very disturbing phenomenon that U.S. companies are doing their IPOs abroad," said Scott. "That is a far cry from U.S. companies delisting and trading abroad but if things continue in this fashion, I expect that will happen."

NIPC agrees with Hal Scott and we lay the blame squarely on the shoulders of the SEC for causing the harm done to investors and issuers by authorizing the redefinition of securities outside the settlement cycle.

Conclusion

Congress could have used its power under the Commerce Clause to create a uniform federal corporation law, but to date, with very modest exceptions, it has not chosen to do so. Congress has left the law governing the internal affairs of our corporations and their stockholders to the states.

Because of this, in order to solve the paper work and financial crisis, it was necessary for the SEC to get the states to adopt the UCC and amend it, as it was in 1994, in order to permit book entry movements of securities on a national level, because the states have jurisdiction in required areas that the SEC does not.

However, with the adoption of the *de facto* "UCC rule", the SEC and market participants are applying the UCC in ways in which it was never intended to be used. This is evident in the conflicts with federal and state corporate and securities laws. Using the UCC in this way exceeds the SEC's statutory authorization.

The book entry movements of securities that the UCC and federal securities laws have made possible, and to which the states agreed to in adopting the UCC, were not meant to be used to create delivery failures past T+3 or to take the place of federally defined "securities" in customer accounts past T+3. As a matter of fact, the UCC was implemented for the opposite reason - to immobilize securities and permit book entry movements in order to be able to settle with the contracted for

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securities within the settlement cycle. Given that a host of federal and state securities laws and state corporate governance laws are violated when the UCC is applied as authorized under the *de facto* “UCC rule”, it becomes clear that the “UCC rule” is a misapplication of the UCC.

The redefinition of securities in customer accounts past T+3 into “securities entitlements” as defined by the UCC is preempted by the superior federal laws and their definition of security and even by UCC’s original intent. The SEC simply can not exempt a series of applicable federal and state laws in a *de facto* manner.

Even if such a rule were promulgated under the APA, *which is what the SEC should do if it believes delivery failures are necessary*, it would quickly learn of the unacceptable costs for equity investor and issuers. Since the “UCC rule” was never put to the public, the SEC never had to examine or consider these cost issues.

The purpose of the proposed “**Customer Account Rule**” is to remedy the harm caused by the “UCC rule” by requiring that customer accounts always accurately reflect the type and number of securities held for customers past the settlement cycle at all times and to ensure that market participants do not hold undisclosed inferior securities for customers than those customer have paid for.

The “**Customer Account Rule**” will also be self policing and self enforcing, in that all failed trades are broken. This removes the financial incentive to effect delivery failures past T+3 to begin with, reducing the resources needed to ensure market integrity, as this feature will automatically guarantee the integrity of all trades. It will also remove undisclosed counter party risks for customers and possibly save customers and tax payers money, should customers be affected by a counter party failure and cause a systemic risk, as is currently possible and recently happened.

Section 6(b)(5) of the Securities Exchange Act of 1934 requires fair treatment of all, which is what the proposed “**Customer Account Rule**” seeks to achieve.

I would be happy to discuss this petition with the SEC and I can initially be contacted via email at info@investorprotectioncoalition.org

Sincerely Submitted,



Thomas Vallarino,
President, National Investor Protection Coalition



Exhibit A

We ask that the SEC respond to one of the four requests below, as quickly as possible

1. We request that the Securities Exchange Commission adopt the proposed “Customer Account Rule” per the APA, contained in Exhibit B
2. We request that the SEC respond in writing for the basis of its decisions should the SEC decide to adopt or promulgate an amended version of this rule instead of the proposed version
3. We ask that the SEC respond in writing for the basis of its decisions should the SEC decide not to adopt either our proposed “Customer Account Rule” nor an amended version
4. We ask that the SEC clearly state in a written response, should the SEC believe that it has **not** authorized any market participant to either,
 - (a) redefine “security” in customer accounts past the settlement cycle from “security” as defined in federal securities laws, to “security” as defined in the UCC
 - (b) effect fails to deliver of securities past the settlement cycle



Exhibit B

Text of proposed “Customer Account Rule”

1. **On purchase transactions, if by the end of the settlement cycle, broker-dealers can not obtain securities on behalf of customers in the quantity and of the type customers have contracted for, or if broker-dealers are otherwise unable to fulfill any requirement of the purchase order, the trade shall be “broken” and –**
 - (a) in the case where customer orders permit a partial order to be filled, broker-dealers shall return to customer accounts purchase funds for the securities that broker-dealers can not obtained on behalf of customers, including commissions, spreads or fees that were paid by customers to obtain the unsettled portion of the trade
 - (b) in the case where customer orders do not permit a partial order to be filled, broker-dealers shall return to customer accounts all purchase funds for the entire order, including commissions, spreads or fees that were paid by customers to obtain the securities
 - (c) customer purchase funds in (a) are to be returned to customer accounts, no later than four hours after the start of the next business day after the settlement cycle ends
 - (d) at the end of the settlement cycle, any securities credited to customer accounts are to be debited from customer accounts in the same number and of the same type as those that broker-dealers failed to obtain on behalf of customers
2. **When customer fully paid for securities are hypothecated for any reason and under any agreement from customer accounts, broker-dealers shall –**
 - (a) debit securities from customer accounts in the same number and of the same type as the hypothecated securities
 - (b) not credit to customer accounts securities in greater numbers than the number that broker-dealers obtain on behalf of customers
3. **When customer excess margin securities are hypothecated for any reason and under any agreement from customer accounts, broker-dealers shall –**
 - (a) debit securities from customer accounts in the same number and of the same type as the hypothecated securities
 - (b) not credit to customer accounts securities in greater numbers than the number that broker-dealers obtain on behalf of customers
 - (c) maintain sufficient replacement NMS securities for customers, in which no market participants are considered counter parties or issuers or guarantors, that are considered NMS securities, that have a market-to-market value no

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- less than 140% of the market-to-market value of the hypothecated securities, that are credited to customer accounts
- (d) permit customers to sell the replacement NMS securities at any time, that are credited to customer accounts
 - (e) credit sales proceeds to customer accounts from the sale of NMS replacement securities, not to exceed the current market-to-market value of the hypothecated customer securities determined at the time of sale

4. Any person violating any part of this rule, shall –

- (a) be considered in violation and committing an offense, regardless of intent
- (b) be considered to have committed one offense, if the aggregate number of shares handled in contravention of this rule is or exceeds 10,000 or if the aggregate value of the shares mishandled is \$10,000 or more
- (c) be considered causing one offense for each trading day that the threshold in (b) occurs
- (d) pay a fine equivalent to three times the realized gains earned in connection with the rule violation, to the customers whose accounts were mishandled and have their securities license suspended for a period of no less than 1 year
- (e) on a third offense, have their securities licenses suspended for a period of no less than 3 years and be incarcerated for a period of no less than 6 months
- (f) on a fourth offence, lose any securities licenses for life and be incarcerated for a period of no less than 2 years and be barred from the securities industry for life

