Susanne Trimbath, Ph.D. u
CEO and Chief Economist u

STP Advisory Services, LLC

May 30, 2008

Ms. Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-08-08

Dear Secretary Morris:

I write in support of proposed Rule 10b-21 to establish liability for settlement failures (“fails to deliver). The term “settlement means the delivery and receipt of funds *and* securities. Indeed, whether a particular transfer qualifies as a settlement payment depends on whether it involves an exchange of consideration and securities in connection with the completion of a securities transaction. If securities have not been delivered, then settlement clearly has not occurred. Settlement finality is a key component of market integrity. It provides assurances to both buyers and sellers that a trade will be completed.

Settlement finality is essential to the securities market. A systemic crisis could occur when settlement fails in one market segment cause widespread volatility in the financial system as a whole.[1] Further, investors are harmed if they make payments in securities transactions and do not receive securities. The markets and investors need the assurance of Rule 10b-21 that securities transactions will be settled especially in times of financial market volatility.

While I find Rule 10b-21 timely, I have a few concerns regarding the assumed effectiveness of Rule 203(b)(3) plus the potential for moral hazard behavior under Rule 10b-21 and the departure from the standard of ordinary care expected from broker-dealers.

<u>General Concerns</u>
Relying on close-out requirements under Rule 203(b)(3)(iii) of Regulation SHO, the Commission discusses the requirement for “immediate action to close out a fail to deliver position in a threshold security in the Continuous Net Settlement (CNS) system that has persisted for 13 consecutive settlement days by purchasing securities of like kind

---

[1] For example, my research shows that failures to deliver occurred in 15% of mortgage-backed securities (MBS) trades in 2005 and 8.9% in 2006. By the time the settlement fail rate in MBS receded to the level of other bonds in 2007, the entire credit market was in turmoil. For the calculation of fail rates see *Settlement Failures in Bond Markets*, available from the Social Science Research Network at http://ssrn.com/abstract=1016873

21 8 WILSHIRE BOULEVARD, #596
SANTA MONICA, CA 90403
(310) 285-8153

and quantity. Statistical evidence indicates that this rule is not effective. From December 2006 to December 2007, fails to deliver at the National Securities Clearing Corporation (NSCC) increased by 99%.[2] At the same time, the value of transactions entering CNS increased by only 62%.[3] While I agree completely that broker-dealers need the "additional encouragement of Rule 10b-21 to "deliver shares by settlement date, enforcement of Rule 203(b)(3)(iii) should be the first line of defense against failures to deliver.

In the discussion of proposed Rule 10b-21, the Commission makes further reference to Regulation SHO and the responsibility of the broker-dealer "for determining whether there are reasonable grounds to believe that a seller will settle.[4] If proposed Rule 10b-21 assigns liability only to the seller, then this could allow the broker-dealer to take no responsibility for their decision to accept the sell order. Because the broker-dealer will be paid a commission only if the trade order executes, the combination of circumstances establishes a situation whereby moral hazard behavior is induced on the part of the broker-dealers. Their economic incentives are aligned in favor of accepting sell orders that have some risk of delivery failure. The only way to mitigate this effect is to place at least some of the liability on the broker-dealer for executing the order.

The possible motivation for a broker-dealer to be less than strenuous in defining "reasonable grounds leads to my final concern. The discussion in proposed Rule 10b-21 allows that a broker-dealer may be deceived by a seller "making misrepresentations about shares that are difficult or expensive to borrow. Shouldn't a broker-dealer be themselves in possession of such basic knowledge about securities they are dealing in? To allow that the broker-dealer would not know enough about the security to know if there are shares available for borrowing and/or delivery would, in my opinion, be a departure from the standards of ordinary care that investors have come to expect from broker-dealers and, in fact, from all financial intermediaries in US securities markets.

Specific Comments Requested

- Proposed Rule 10b-21 should apply to all securities, not just sales of "threshold securities. In fact, the value of settlement failures in the bond markets is many times that of equity markets. My research shows that bond trade fails also increased from 2006 to 2007, though not at the rate of increase seen in equity trades. While some progress was made to reduce bond market settlement failures from about 8% of all trades to less than 5% from 2005 to 2006, bond trades failed at an increased rate of 5.4% in 2007. Preliminary data for 2008 indicate that this will be a record year for

[2] Fails to deliver at NSCC were $3,749,160,000 at year-end 2006 and $7,454,648,000 at year-end 2007. Source: NSCC Annual Financial Statements, 2007.
[3] Includes equity, bond and ETF transactions. Source: Depository Trust and Clearing Corporation, Annual Report, 2007. The systemic risk also continues to rise: NSCC's Clearing Fund at year-end 2007 was only $4,866,576,000, an increase of just 60% over the previous year.
[4] Page 15377, File S7-08-08.

settlement failures.[5] Therefore, I encourage the Commission to reject consideration of any limitations on the application of Rule 10b-21.

- The proposed rule will have a positive impact on liquidity and market quality in securities traded. Settlement finality requires not only the payment of consideration but also the delivery of securities in order for trades to be completed. Without strict rules against settlement failures, a systemic crisis could occur where investors are reluctant to engage in trades in US markets because settlement finality is in question. The markets and investors need the assurance of Rule 10b-21 that securities transactions will be settled.

Impact on the Economy

There is a monetary benefit to investors from enforcing delivery on settlement date. During the period that the shares are not received, the investor will receive payments in lieu of dividends. These payments are excluded, under IRS rules implemented in 2004, from the favorable tax rate afforded to dividends.[6,7] NSCC reported that shares valued at $5,761,192,000 failed to be delivered for settlement as of December 31, 2007. The difference between the tax rate on qualified dividends and the tax rate on ordinary income is between 10% and 20%.[8] Assuming these shares have an average 1% dividend yield, then investors are paying between $5,761,192 and $11,522,384 in excess taxes each year.[9] Further, research shows that many firms initiated dividends following the dividend tax cut in the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003.[10]

[5] Nearly 9% of US Treasury trades resulted in a failure to deliver in the first 5 months of 2008, compared to 1.2% in the same period last year. This figure is for trades involving Primary Dealers only and may be substantially higher for all trades.

[6] Section 6045(d) reflected the changes to information reporting for payments in lieu of dividends effected by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Implementation was delayed to 2004 at the request of broker-dealers who commented that they needed additional time to implement system changes.

[7] Conversely, broker-dealers may not be reporting these payments as “in lieu. In that case, the investor does not suffer a monetary loss. Instead the loss accrues to the federal government (i.e., taxpayers). If “payments in lieu are reported as bona fide dividend payments, the IRS will collect less revenue (income tax payments) than they would have had the payments been properly reported as “in lieu.

[8] The tax rate on qualified dividends is 5% or 15% (depending on the individual's income tax rate). If the individual has a regular income tax rate of 25% or higher, then the qualified dividend tax rate is 15%. If the individual's income tax rate is less than 25%, then qualified dividends are taxed at the 5% rate.

[9] The mean dividend yield for the S&P 1500 was 0.9% in 2003. See Jeffrey R. Brown, Nellie Liang and Scott J. Weisbenner, *Executive Financial Incentives and Payout Policy: Firm Responses to the 2003 Dividend Tax Cut* (December 2004). Available from the Social Science Research Network: http://ssrn.com/abstract=631182. Their calculation of the average dividend yield includes firms that do not pay dividends, making the calculation relevant even if there are non-dividend paying companies among those whose shares were not delivered to NSCC. The question of whether the failure to receive occurred on a dividend record date is less relevant because the value of shares that investors fail to receive has never been zero. In fact, most academic research on the subject shows that the activity leading to payments in lieu of dividends actually increases around record dates.

[10] “[A]mong S&P 1500 non-dividend-paying firms, the fraction that initiated dividends jumped from only one in a hundred firms in 2001and 2002 to nearly one in ten firms in 2003. See Jeffrey R. Brown, Nellie Liang and Scott J. Weisbenner, *Executive Financial Incentives and Payout Policy: Firm Responses to the*

Therefore, it is likely that the monetary benefit to investors from a reduction in settlement failures will increase across time.[11,12]

Further, investors incur economic damages when they are denied the use of funds between trade date and actual delivery date. Using publicly available data on failures to deliver in NYSE and NASDAQ “threshold securities alone, I calculate that loss to have been $762 million in 2007.[13] This is not a one-time loss but an on-going monetary loss to investors that will not diminish as long as the system tolerates failures to deliver.

Concluding Remarks

The clearance and settlement system depends on guarantees by all participants that they will perform their obligations. Uncertainty about the final status of entitlements could lead participants to engage in certain types of activities that are detrimental to the 50.3% of American households who own US equities.[14] Confidence in the securities markets is diminished when investors and others cannot rely on the receipt of securities in trades. During the time that there is uncertainty in the securities markets about the receipt of securities in settlement, investors’”confidence will diminish. Tolerance for settlement failures seriously undermines the protections that should be afforded all investors in US securities markets.

Sincerely,
Susanne Trimbath, PhD

cc: Internal Revenue Service, Administrative Provisions and Judicial Practice; General Accounting Office, Financial Markets and Community Investment

---

2003 Dividend Tax Cut (December 2004). Available from the Social Science Research Network: http://ssrn.com/abstract=631182.

[11] A significant percentage of households reporting dividend income are either retired or earn less than $50,000 per year. Speaking in support of JGTRRA, James W. Struckert, Chairman of the SIA Regional Firms Committee, said “According to the most recent IRS data, 34.1 million tax returns (or 26.4 percent of total tax returns, representing 71 million people) reported some dividend income in 2000. Of all taxpayers that claimed some dividend income in 2000, nearly half (45.8 percent) earned less than $50,000 in adjusted gross income (including dividends). …”Importantly, almost half of all savings from the dividend exclusion would go to taxpayers 65 and older, thereby giving retirees an additional reliable, long-term source of income to supplement their social security earnings and other retirement savings. The average annual tax savings for the 9.8 million seniors receiving dividends would be $936. Testimony before the Subcommittee on Economic Policy of the Senate Committee on Banking, Housing, and Urban Affairs, May 22, 2003.

[12] Furthermore, interest paid on municipal bonds in the US is exempt from federal taxes. When bond trades fail the investor gets a payment in lieu of interest. Unlike dividends, these payments are not differentiated by the broker. As a result, the US government is missing out on $1.54 billion per year in tax revenue.

[13] Calculations for 2006 are available in the appendix to *Settlement Failures in Bond Markets*, available from the Social Science Research Network at http://ssrn.com/abstract=1016873. An updated paper, including calculations using data through mid-2008, is forthcoming.

[14] Source: *Equity Ownership in America, 2005*, Investment Company Institute and Securities Industry Association. According to Federal Reserve data, nearly three-fourths (73 percent) of Americans’”liquid financial assets are invested in securities-related products.