On October, 19, 2006, Dr. Trimbath presented comments as part of a panel discussion called *Naked, Short and Greedy: Is Wall Street Abusing the Practice of Short-Selling Stocks?* which was presented by STP Advisory Services, LLC. The event was held at the Park Hyatt Hotel in Los Angeles, CA. Her speech describes the potential for damage to voting rights, share prices, dividends, tax exemptions, and the ability of small business to finance growth. Some graphics from the accompanying slide presentation are included in this publication. The text may also include references and citations that were not in the verbal presentation.

1. INTRODUCTION

My purpose in speaking today is to talk about what is happening to shareholders and investors. In doing this, I will have to explain how short sales and stock loans are tied to settlement failures through the Depository Trust & Clearing Corporation, or DTCC. Here's what happened to one investor I know. Helen [not her real name] went to her broker at Penson Financial Services between June and September of 2003 and said, "Buy shares of JAG Media" and the broker said, "Fine." Every trade was listed on her brokerage account statement as settled exactly three days later. In the end, Penson credited her account with a total of almost 28,000 shares of JAG Media and debited her account for over $12,000 in cash. Those shares of JAG Media provided a 140% return on investment over the next 12 months. Helen should have lived happily ever after. But she asked the right questions and found out that there really was no stock in her account and that Penson had been using her money for free during that year. Penson eventually admitted in writing that the trades did not settle in 3 days. Helen eventually got her shares but she believes that Penson profited by the year of delay. Her retail broker told her there were delays at the transfer agent and delays at the company. But I'm here to tell you that she was tricked into giving Penson a free loan of cash.

2. OUTLINE

I'll begin today by talking about short sales and then I'll spend a few minutes talking about stock lending. To get to the heart of the problem, I'll need to talk about settlement at the DTCC. Inside the black box of DTCC operations is the main place where phantom shares are created. I'll try to get through most of this without getting too technical. In the end, I believe you'll understand why the goose that lays golden eggs for your broker-dealer is dropping something entirely different at **your** doorstep.

SHORT SALES:

- **Offset Market Over-Exuberance**
- **Distribute or Balance Investment Risk**
- **Alternative Investment Strategy**

---------------OR--------------------

- **Distort Market Information**
- **Create Over-Supply of Shares**
- **Destructive Investment Strategy**

3. SHORT SALES

To begin with, the most obvious reason investors are damaged by short sales is that short sellers are betting that a stock price will fall so they can profit from the decline. Investors and issuers are betting the other way, that the share price will rise. In fact, they are working toward that goal by building a company that has value. While some believe that short sellers play a balancing role in the capital markets – balancing any over-exuberance on the buy-side – it's not entirely clear that there is a balance within the short seller side of the industry itself. **For every stunning success by the short side, for every discovery of an Enron-level scandal, I can find 10 civil and criminal prosecutions of stock loan and short sales participants.**

4. TROUBLED INDUSTRY

Short sellers can't operate legally without stock lending, and that industry has a troubled history. Here are a few examples to show that the problem has been around a long time. First, there is the 1984 case involving a night supervisor at Depository Trust Company or DTC. There was a scheme involving fraudulent stock loan transactions and the embezzlement of over $700,000. They had the DTC employee transfer as much as $20 million worth of stock to dormant accounts that they then used for stock loan before DTC discovered the transfer. Meanwhile, the co-conspirators enjoyed the use of the monies from the stock loans.

In 1986 a Merrill Lynch supervisor pleaded guilty to three felony charges related to a stock borrow scheme. Another stock-loan abuse probe in 1989 resulted in guilty pleas from Shearson Lehman. Again, there were problems with stock loan finders getting fees for loans that were never arranged. Thomson McKinnon settled a civil case with the SEC in 1989 for letting the stock loan department use securities that should not have been lent.

In 2006, a year after Reg SHO was implemented by the SEC, the NYSE announced that they were preparing to launch a series of investigations, including investigations on the same problems that occurred in 1984 and 1989. There is no reason to believe that this decade's regulation and enforcement will be any better than regulation and enforcement in the last two decades. NYSE is also again investigating instances where stock loan departments use securities they have no right to lend. Fines have already been levied against a long list of companies in 2006 for improper short sales amounting to thousands of transactions. The problem of firms lending securities that they shouldn't will ultimately impact a far wider group of investors.

5. INSIDE THE BLACK BOX

I worked not only at DTC in New York, but also with the Pacific Clearing Corporation in San Francisco. I have the experience necessary to talk about what happens inside clearing and settlement. Please don't misquote me as saying I worked for DTCC because I actually worked for their predecessor DTC, with only one C. Last February a reporter in New Jersey put an extra "C" in my resume and DTC**C** had to issue a media statement clarifying my employment record. Let's not put them to that trouble again, OK? Seriously, all the details of my background are in my bio.

Well, if all of Wall Street is a stage, then DTCC is running everything that happens back stage. They are the guys who run the lights and cameras; the grips and gaffers that movie goers don't know what they do nor do they need to care. But we all need to care about what's happening backstage on Wall Street.

The problem is that when trades are settled with borrowed shares, the lender gives the dividend and voting rights to the buyer. The buyer has full ownership rights including the right to lend that share to another borrower. This is how shares "multiply" into phantom shares.

6. HOW BIG IS IT?

Trades settled with borrowed shares leave open a failure to receive. The distinction between deliver and receive is made clear in NSCC's Annual Financial Statements:

> "The failure of participants to deliver securities to NSCC on settlement date, and the corresponding failure of NSCC to redeliver the securities, results in open positions. … At the close of business on December 31, 2005, open positions due to NSCC approximated $3,423,028,000, and open positions due by NSCC to participants approximated $2,445,326,000 for unsettled positions and $977, 702,000 for securities borrowed…"

In other words, there were about $3.4 billion in *fails to deliver* and about $2.4 billion in *fails to receive* for total open fails of about $5.6 billion or roughly the $6 billion that DTCC publicizes. However, when we include the nearly $1 billion in *fails to receive* that were covered by stock borrowing, the total *level of fails* is closer to $7 billion. Compare that to the $6 billion figure that DTCC publicizes and you should begin to understand the deep concern of the affected companies and investors.

7. WHAT YOU DON'T KNOW

Most people, when I explain this to them, their first reaction is to run home and put all their money under their mattress. When I give this speech, I run the risk of having the audience make a mad dash from the room. I'm glad to see so many of you have decided to stay with me. The problems are usually first identified by the issuer when they see a sudden, unexplained drop in the share price. Too many times I hear a CNBC reporter say, "Well, that's good news for company XYZ. Their share price is…oh, it dropped. Well, that doesn't make sense." The connection between share price and firm performance has been broken. Pretty soon, a large shareholder complains about not being able to get delivery of the shares they purchased. Eventually, there is a spike in the short interest accompanied by an attempted over-vote in the proxies. The next thing you know, the company is on the Regulation SHO Threshold list because DTCC Participants have settlement failures that exceed ½ percent of the shares issued and outstanding.

What You Don't Know May Hurt You

- **Share Prices ≠ Company Performance**
- **Investors unaware when shares are loaned or they are "tagged" as buyer in a settlement failure**
- **BDs throw out votes or assign votes by lottery**

8. TRIUMVIRATE OF TROUBLE

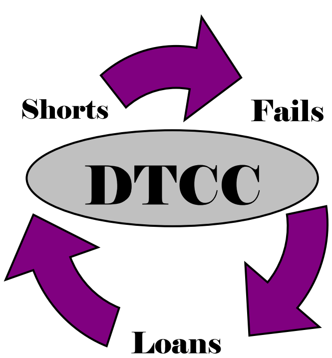
- **Shorts: Dilution of value and votes**
- **Loans: No rules and broken rules for proxy voting rights; Dividends become taxable "in lieu"**
- **Fails: Unknown number of investors all believe they own shares; phantom shares exchanged for cash; unknown impact on dividend payments**

Because the difference in price from sell to buy is taken as profit, an unscrupulous short seller has an economic incentive to sell as much as possible – to attempt to drive the price down – in order to increase profits. In a covered short sale, the seller pays to borrow the shares. The cost of that loan – including "margin calls" if the shares' price rises against the short bet – puts pressure on the seller to close out their position. In a naked short sell the shares are not borrowed, a practice that is allowed under very limited circumstances. But the technical definition of naked short selling is not what we are talking about today. With legitimate short selling (naked or otherwise), the dilution of share value and shareholder rights will be corrected when the short positions are closed: the market price of the shares will move toward the real value of the firm as shares are borrowed to cover the short sale and ultimately as shares are purchased to repay the loan.

When settlement failures are added to the picture, the shorts have no incentive to cover. The trade may be allowed to remain unsettled indefinitely; there is no margin call because there is no stock loan. When a trade is executed, regardless of whether the trade is marked "long" or "short," if the shares are not presented at settlement, the customer pays for those shares, and they are led to believe that they have those shares in their account when they don't.

9. THREE ISSUES ONE PROBLEM

To be perfectly clear, the source of the problem is three-fold – short sales, stock lending and settlement failures. The short sellers can harm a company's reputation and damage the share price, both of which limit the firm's ability to access capital. Investors are damaged by settlement failures because they are not getting real ownership of shares after making payments. Institutional investors, including pension funds like California's teachers and public employees' retirement funds, try to stand on both sides of the problem: as investors, they see the value of their portfolio shares eroded by the short sellers, and then they relinquish their voting rights in pursuit of higher returns by lending their shares to short sellers. **The damage caused by all three issues stems from the core problem, which is a systemic failure to provide secure, guaranteed, final settlement for trades.**



Before anyone thinks this is all crying wolf on the part of disgruntled issuers and investors, let me explain that there is money being made in this process and companies

being driven out of business. NSCC's Annual Financial Statements contain another key to this piece of the puzzle. Settlement failures result in open positions. "*Open positions are marked-to-market daily. Such marks are debited or credited to the involved participants through the settlement process.*"
So, as excessive short selling causes the price of the shares to fall, and each day DTCC will credit back to the failing participant the cash collateral they have put up to borrow shares. If that Participant can drive the price of the shares to zero, the DTCC will further oblige them by declaring the securities "worthless," eliminating any remaining obligations from their records.

10. SECURITIES TRANSFER ASSOCIATION

Some trades are allowed to remain unsettled indefinitely. **Where stock lending takes place, the problems are compounded because there is no due date for the return of shares.** The Securities Transfer Association has been fighting the proxy side of this battle for decades. They started at the stock exchanges who told them that proxy wasn't their problem, it was DTCC's program. So, they went to the DTCC who told them that they were only following the rules approved by the SEC. When they got to the SEC in 2004, they were told: "who cares who votes the shares as long as you don't see it." The DTCC participants can't keep track of whose shares are on loan, who gets the real dividend or whose vote should be counted. **The SEC's philosophy is to intercept the over-reporting of votes from brokers before the data is transmitted to the issuer who would see is as over-voting. In other words, they want to hide it away so they can go on denying there's a rhino behind the couch.** The only agency to take action so far has been the Internal Revenue Service. The IRS requires retail brokers to separate "qualified" and "non-qualified" dividends on the customer 1099's. The reason: payments received in lieu of dividends, which is what investors actually get while their shares are on loan or are recorded as a failed trade, are not qualified for the dividend tax exclusion.

Who in the World Is Working on Solutions?
-------------- NO ----------------
∅ New York Stock Exchange
∅ Depository Trust and Clearing Corporation
∅ Securities and Exchange Commission
-------------- YES ----------------
! Internal Revenue Service !

11. EXAMPLE: SHORTS FOR VOTES

Now I'll bring all three pieces home with data on some real companies. First, there are two companies, Mony and El Paso, where investigative reporter Bob Drummond provided evidence in the April 2006 issue of Bloomberg Markets that the number of phantom shares exceeded the difference in votes cast for and against board approvals, compensation packages and mergers.

- **MONY: short interest jumps 65% on voting record date to 6.2M shares. Axa merger approved by margin of 1.7M shares.**
- **EL PASO: short interest on voting record date is 76M shares. Opposed incumbents elected by 17M shares.**

12. EXAMPLE: GLKC [now gllc.pk]

Next, Global Links is a Nevada real estate company that Liz Moyer wrote about recently in Forbes magazine. Outstanding settlement failures in Global Links topped 27 million shares after a reverse split was systematically botched by financial services operations. There were 10 million Global Links shares in outstanding settlement failures while only 4 million real shares of Global Links had been issued. Almost a year later, there were still nearly 6 million shares due to cover settlement failures. In other words, even if every legal share of Global Links were turned in to DTCC tomorrow, they would still be 2 million shares short.

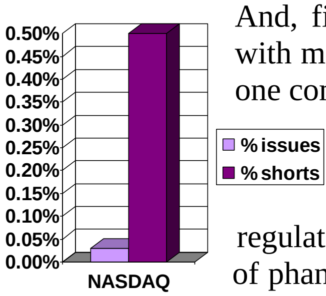
13. EXAMPLE: NFI

It gets worse. I looked at some data received under the FOIA for Novastar Financial. Here, I found evidence of illogical fails. You see, if the price of the stock drops between trade date and settlement date, then it is logical to fail to settle: you can buy the stock cheaper on settlement date to replace it than if you had to pay the original trade price. The SEC published a study a couple of years ago calling these "strategic" fails. What I found, however, were that failures to deliver shares of NFI increased even when the price of the shares rose. To put it another way, failures increased even when it would be more expensive to be bought in at settlement than it would be to deliver shares at the original price. Had the buy in's been executed, it would have cost the sellers $23 million more than the original price. When faced with illogical fails like this, you must ask yourself: "How big was the profit motive that they risked that kind of loss?"

- FTD rose 53% of all days.
- FTD rose 50% of days when price fell.
- FTD rose 60% of days when price rose.

Source: FOIA data, April to December 2004
FTD: Failures to Deliver measured in number of shares

14. EXAMPLE: OVERSTOCK



And, finally, there is Overstock, whose CEO Patrick Byrne is here with me today. Of the more than 3,000 issues listed on the NASDAQ, one company barely registers as a percent of the whole. Yet Overstock shares accounted for one-half of one percent (0.50%) of the increase in short interest in the entire NASDAQ market during 2005. That is, after the implementation of the regulation meant to curb abusive short trading practices. The number of phantom shares would be equivalent to 36% of the total real shares outstanding. My own ballpark estimate is that phantom shares of Overstock could represent as much as 3% of the $6B in fails that DTCC admits it's maintaining.

15. NO SUCH THING AS A FREE MARKET

If, after all that, any one here thinks that some *deus ex machina* or animal spirit market forces are going to correct this after another round of regulation you need to rethink how this situation came to be in the first place. Everything I've shown you today is being done within the existing system, under rules that were written by the groups that are profiting from it: the major banks and the prime brokers. Information would be the cornerstone of a market forces solution to this problem. In this case, however, someone else is in control of the creation of a vital piece of information: the number of shares in circulation. That's information used by investors for critical decision making and for measuring firm performance.

And don't think that this doesn't affect you because you don't own shares of Overstock, or Taser or Martha Stewart or any of the more than 6,000 companies identified by the SEC as severely abused by short selling and settlement failures. Academic research now reveals that short interest spikes around record dates, proving that someone is basically buying votes to get control of corporations in the United States.

16. ALL THAT GLITTERS

There are those who believe that stock lending is the goose that lays that golden egg, providing high levels of income to selected participants. These people think that increased transparency in stock lending and borrowing will solve all the problems.

I offer a different adage in response: All that glitters is not gold. And not all bird droppings are eggs. It will take more than transparency to hold the confidence of investors and companies in the integrity of both the capital market and the regulators. By calling for **simple** solutions like the accurate marking of short sale trades and more stock lending to prevent illegitimate naked short selling, we will only prolong the agony. We must begin now to face the long and difficult process necessary to fix the gaping wholes in the system.

17. CONCLUSION

In summary there exists today no enforceable deadline at which the DTCC participant must either deliver the real shares or return the real money. The final impact of shorts, loans and fails – the triumvirate of trouble – is the decimation of voting rights, share prices, and even dividend tax exemptions, all of which impact investors and issuers. **The toxic mix of shorts and loans combines with the system's tolerance for settlement failures to create a witch's brew that damages issuers and drags down investor confidence in US capital markets.**

For More Information

- **Visit www.STPadvisors.com for copies of research papers and information on appearances.**
- **Read Dr. Trimbath's comments to the SEC on the Amendments to Regulation SHO, available online at: http://www.sec.gov/comments/s7-12-06/strimbath7022.pdf**