SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 200 and 242

[Release No. 34–60388; File No. S7–30–08]

RIN 3235–AK22

Amendments to Regulation SHO

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission (''Commission'') is finalizing amendments to Regulation SHO under the Securities Exchange Act of 1934 (''Exchange Act'') by making permanent amendments contained in Interim Final Temporary Rule 204T (''temporary Rule 204T'') of Regulation SHO, with some modifications to address commenters' concerns. These amendments are intended to help further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission. In addition, these amendments are intended to help further our goal of addressing abusive ''naked'' short selling in all equity securities. These goals will be furthered by requiring that, subject to certain limited exceptions, if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency it must immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position. Failure to comply with the close-out requirement of this final rule is a violation of the rule. In addition, a participant that does not comply with this close-out requirement, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security either for itself or for the account of another, unless it has previously arranged to borrow or borrowed the security, until the fail to deliver position is closed out.

DATES: *Effective Date:* July 31, 2009.

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SUPPLEMENTARY INFORMATION: We are adding Rule 204 of Regulation SHO [17 CFR 242.204] under the Exchange Act and removing Rule 204T of Regulation SHO [17 CFR 242.204T] under the Exchange Act.

I. Introduction

In October 2008, we adopted temporary Rule 204T of Regulation SHO as an interim final temporary rule, with an expiration date of July 31, 2009.[1] As discussed in more detail below, temporary Rule 204T strengthens the close-out requirements of Regulation SHO for failures to deliver securities (known as ''fails'' or ''fails to deliver'')[2] resulting from sales of any equity security. Our adoption of temporary Rule 204T followed a series of other steps aimed at reducing fails to deliver and addressing potentially abusive ''naked'' short selling.[3]

In addition, at the time that we adopted temporary Rule 204T, we noted our concerns about the sudden and unexplained declines in the prices of equity securities generally and the deterioration in investor confidence in our financial markets.[4] Such price declines can give rise to questions about the underlying financial condition of an entity, which in turn can create a crisis of confidence even without a fundamental underlying basis.[5] This crisis of confidence can impair the liquidity and ultimate viability of an entity, with potentially broad market consequences.[6] Thus, we also adopted temporary Rule 204T to further our goal of preventing substantial disruption in the securities markets by providing a powerful disincentive to those who might otherwise engage in potentially abusive ''naked'' short selling.[7]

Preliminary results from the Commission's Office of Economic Analysis (''OEA'') indicate that our various actions to further reduce fails to deliver and, thereby, address potentially abusive ''naked'' short selling are having their intended effect. For example, these preliminary results indicate a significant downward trend in the number of fails to deliver in all equity securities since, among other actions, the adoption of temporary Rule 204T.[8] These results provide, among other things, that in comparing a pre- to post-temporary Rule 204T adoption period,[9] the average daily number of fails to deliver for all equity securities has declined from 1.1 billion to 478 million for a total decline of 56.6 percent. In addition, the average daily number of threshold securities declined from 480 securities to 108 securities in comparing the pre- to post-temporary Rule 204T adoption period, a decline of 77.5%.[10]

Due to the positive impact that temporary Rule 204T,[11] as well as other recent Commission actions, are having on reducing fails to deliver and after considering the comments received to temporary Rule 204T, we are adopting the provisions of that rule in a permanent rule, Rule 204 of Regulation SHO, with some limited modifications to refine provisions and address commenters' concerns.[12] In general, as discussed in more detail below, we are maintaining the structure of temporary Rule 204T, while making some

[1] *See* Exchange Act Release No. 58733 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) (''Rule 204T Adopting Release'').

[2] Fails to deliver occur when a seller fails to deliver securities to the buyer when delivery is due. *See infra* note 16 and accompanying text.

[3] *See infra* Section II (discussing other Commission actions aimed at reducing fails to deliver and addressing potentially abusive ''naked'' short selling).

[4] *See* Rule 204T Adopting Release, 73 FR 61707.

[5] *See id.*

[6] *See id.*

[7] *See id.*

[8] *See* Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, November 26, 2008 at *http://www.sec.gov/comments/s7-30-08/s73008-37.pdf; see also* Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, March 20, 2009 at *http://www.sec.gov/comments/s7-30-08/s73008-107.pdf*; Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, April 16, 2009 (''OEA April 2009 Memorandum'') at *http://www.sec.gov/comments/s7-30-08/s73008-121.pdf.*

[9] The OEA April 2009 Memorandum defined the pre-Rule period as the period from January 1, 2008 to September 22, 2008, and the post-Rule period as September 23, 2008 to March 31, 2009. The post-Rule period was also post elimination of the options market maker exception to Regulation SHO's close-out requirement in Rule 203(b)(3) of Regulation SHO. *See* OEA April 2009 Memorandum; *see also infra* notes 38–41 and accompanying text.

[10] *See* OEA April 2009 Memorandum.

[11] We note in this regard that at a public Roundtable to Examine Short Sale Price Test and Circuit Breaker Restrictions held on May 5, 2009 (the ''Short Sale Price Test Roundtable''), a number of participants of the Roundtable commented on the success of temporary Rule 204T at reducing fails to deliver and urged the Commission to adopt temporary Rule 204T as a permanent rule. *See, e.g., http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.txt.*

[12] We received approximately 120 comment letters in response to the Rule 204T Adopting Release. The comment letters are available on the Commission's Internet Web site at *http://www.sec.gov/comments/s7-30-08/s73008.shtml.* Further, as noted above, a number of participants at the Commission's Short Sale Price Test Roundtable expressed views about temporary Rule 204T. *See e.g., http://www.sec.gov/spotlight/shortsales/roundtable050509/shortsalesroundtable050509-transcript.txt. See also* comments to the Short Sale Price Test Roundtable at *http://www.sec.gov/comments/4-581/4-581.shtml.*

adjustments to promote its workability.[13]

We believe that Rule 204 of Regulation SHO will continue to help further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission. In addition, these amendments are intended to help further our goal of addressing potentially abusive ''naked'' short selling. These goals will be furthered by, among other things, requiring that securities are purchased or borrowed to close out any fail to deliver position resulting from a short sale of an equity security by no later than the beginning of regular trading hours on the settlement day following the date on which the fail to deliver position occurred. Similar to temporary Rule 204T of Regulation SHO, Rule 204 will continue to provide a disincentive to those who might otherwise engage in potentially abusive ''naked'' short selling.

II. Background

Short selling involves a sale of a security that the seller does not own or a sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.[14] Short sales normally are settled by the delivery of a security borrowed by or on behalf of the seller. In a ''naked'' short sale, however, the short seller does not borrow securities in time to make delivery to the buyer within the standard three-day settlement period.[15] As a result, the seller fails to deliver securities to the buyer when delivery is due.[16] Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security,[17] or possibly to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high.

We have been concerned about reducing fails to deliver and addressing ''naked'' short selling, in particular, potentially abusive ''naked'' short selling, for some time. As we have stated on several prior occasions, we believe that all sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased.[18] In addition, as we have stated on several prior occasions, we are concerned about the negative effect that fails to deliver may have on the markets and shareholders.[19]

For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending.[20] In addition, where a seller of securities fails to deliver securities on settlement date, in effect the seller unilaterally converts a securities contract (which is expected to settle within the standard three-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.[21] Moreover, sellers that fail to deliver securities on settlement date may attempt to use this additional freedom to engage in trading activities to improperly depress the price of a security. By not borrowing securities and, therefore, not making delivery within the standard three-day settlement period, the seller has additional freedom because it does not incur the costs of borrowing.

In addition, issuers and investors have repeatedly expressed concerns about fails to deliver in connection with manipulative ''naked'' short selling. For example, in response to proposed amendments to Regulation SHO in 2006,[22] which were designed to further reduce the number of persistent fails to deliver in certain equity securities by eliminating Regulation SHO's ''grandfather'' exception and limit the duration of the rule's options market maker exception, we received a number of comments that expressed concerns about ''naked'' short selling and extended delivery failures.[23] Commenters continued to express these concerns in response to proposed amendments to eliminate the options market maker exception to the close-out requirement of Regulation SHO in 2007[24] and in response to the Rule 204T Adopting Release.[25]

To the extent that fails to deliver might be part of manipulative ''naked'' short selling, which could be used as a tool to drive down a company's stock price,[26] such fails to deliver may

[13] *See infra* Section III (discussing Rule 204 of Regulation SHO and commenters' concerns).

[14] 17 CFR 242.200(a).

[15] *See* Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48009 n. 10 (Aug. 6, 2004) (''2004 Regulation SHO Adopting Release'').

[16] Generally, investors complete or settle their security transactions within three settlement days. This settlement cycle is known as T+3 (or ''trade date plus three days''). T+3 means that when a trade occurs, the participants to the trade deliver and pay for the security at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange those funds for the securities on that third settlement day. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next settlement day following the trade (or T+1). In addition, Rule 15c6–1 prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6–1; Exchange Act Release No. 33023 (Oct. 7, 1993), 58 FR 52891 (Oct. 13, 1993). However, failure to deliver securities on T+3 does not violate Rule 15c6–1; *see also* Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544, n. 2 (Aug. 14, 2007) (''2007 Regulation SHO Final Amendments'').

[17] In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of a corporation. The Commission alleged that the defendants profited from engaging in massive ''naked'' short selling that flooded the market with the stock, and depressed its price. *See Rhino Advisors, Inc. and Thomas Badian,* Lit. Rel. No. 18003 (Feb. 27, 2003); *SEC* v. *Rhino Advisors, Inc. and Thomas Badian,* Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y); *see also* Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (''2003 Regulation SHO Proposing Release'') (describing the alleged activity in the case involving stock of Sedona Corporation); 2004 Regulation SHO Adopting Release, 69 FR 48016, n.76; Exchange Act Release No. 58774 (Oct. 14, 2008), 73 FR 61666 (Oct. 17, 2008) (''Anti-Fraud Rule Adopting Release'').

[18] *See, e.g.,* Rule 204T Adopting Release, 73 FR 61709; Exchange Act Release No. 57511 (Mar. 17, 2008), 73 FR 15376, 15377 (Mar. 31, 2008) (''Anti-Fraud Rule Proposing Release'').

[19] *See, e.g.,* Rule 204T Adopting Release, 73 FR 61709; 2007 Regulation SHO Final Amendments, 72 FR 45544; Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710, 41712 (July 21, 2006) (''2006 Regulation SHO Proposed Amendments''); Exchange Act Release No. 56213 (Aug. 7, 2007), 72 FR 45558, 45558–45559 (Aug. 14, 2007) (''2007 Regulation SHO Proposed Amendments''); Anti-Fraud Rule Proposing Release, 73 FR 15378.

[20] *See id.*

[21] *See id.*

[22] *See* 2006 Regulation SHO Proposed Amendments, 71 FR 41710.

[23] *See, e.g.,* letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006 (''Overstock''); letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, TASER International, dated Sept. 18, 2006; letter from John Royce, dated April 30, 2007; letter from Michael Read, dated April 29, 2007; letter from Robert DeVivo, dated April 26, 2007; letter from Ahmed Akhtar, dated April 26, 2007.

[24] *See, e.g.,* letter from Jack M. Wedam, dated Oct. 16, 2007; letter from Michael J. Ryan, Executive Director and Senior Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated Sept. 13, 2007 (''U.S. Chamber of Commerce''); letter from Robert W. Raybould, CEO Enteleke Capital Corp., dated Sept. 12, 2007 (''Raybould''); letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 12, 2007 (''NCANS'').

[25] *See e.g.,* letter from Roel Campos, dated Mar. 25, 2009 (''Campos''); letter from the Risk Management Association, dated Dec. 23, 2008; letter from Professor James Angel, Ph.D, CFA, dated Dec. 17, 2008 (''Angel''); letter from Patrick Byrne, Ph.D., dated Dec. 16, 2008; letter from the American Bankers Association, dated Dec. 16, 2008 (''ABA''); letter from Fairfax Financial Holdings, Ltd., dated Oct. 16, 2008.

[26] *See supra* note 17 (discussing a case in which we alleged that the defendants profited from engaging in massive ''naked'' short selling that flooded the market with the company's stock, and

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undermine the confidence of investors.[27] These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[28] In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding fails to deliver in the issuer's security.[29] Unwarranted reputational damage caused by fails to deliver might have an adverse impact on the security's price.[30]

Although the majority of trades settle within T+3,[31] we adopted Regulation SHO[32] on July 28, 2004, in part to address problems associated with persistent fails to deliver securities and potentially abusive ''naked'' short selling. For example, Regulation SHO requires broker-dealers to ''locate'' securities that the broker-dealer reasonably believes can be delivered within the standard three-day settlement period.[33]

Another requirement of Regulation SHO aimed at potentially abusive ''naked'' short selling and reducing fails to deliver in certain equity securities is the rule's ''close-out'' requirement. Since Regulation SHO was adopted it has required participants[34] of a registered clearing agency,[35] which includes broker-dealers, to purchase shares to close out fails to deliver in securities with large and persistent fails to deliver, *i.e.,* ''threshold securities.''[36] Until the position is closed out, the participant responsible for the fail to deliver position and any broker-dealer from which it receives trades for clearance and settlement may not effect further short sales in that threshold security without first borrowing or arranging to borrow the security.[37]

As adopted, Regulation SHO included two major exceptions to the close-out requirement: The ''grandfather'' provision and the ''options market maker'' exception. The ''grandfather'' provision had provided that fails to deliver established prior to a security becoming a threshold security did not have to be closed out in accordance with Regulation SHO's thirteen consecutive settlement day close-out requirement.

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depressed its price); *see also S.E.C.* v. *Gardiner,* 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. Mar. 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price); *U.S.* v. *Russo,* 74 F.3d 1383, 1392 (2d Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b–5).

[27] In response to the Rule 204T Adopting Release, we received comment letters discussing the impact of fails to deliver on investor confidence. *See e.g.,* letter from David Patch, dated Mar. 19, 2009; letter from Charles J. Greiner, dated Mar. 11, 2009. In response to the 2007 Regulation SHO Proposed Amendments, commenters discussed the impact of fails to deliver on investor confidence. *See, e.g.,* letter from NCANS. Commenters expressed similar concerns in response to the 2006 Regulation SHO Proposed Amendments. *See, e.g.,* letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 (''NCANS (2006)''); letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 (''Blumenthal'').

[28] In response to the Rule 204T Adopting Release, we received comment letters expressing concern about the impact of potential ''naked'' short selling on capital formation, claiming that ''naked'' short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets. *See, e.g.,* letter from Campos (noting that ''[i]n its most benign form, naked short selling is a hidden tax on equity markets, our largest wealth creation mechanism. At its worst, it is a violent force of wealth destruction that affects all market participants.''); letter from Patrick Byrne Ph.D., Chairman and Chief Executive Officer, Overstock.com Inc., dated Dec. 16, 2008 (stating that ''more needs to be done to correct the problem of naked short selling and to prevent more companies from being taken down by those that use it as a tool for manipulation.''); *see also* letter from ABA. Commenters expressed similar concerns in response to the 2007 Regulation SHO Proposed Amendments. *See, e.g.,* letter from Robert K. Lifton, Chairman and CEO, Medis Technologies, Inc., dated Sept. 12, 2007 (''Medis''); letter from NCANS. Commenters also expressed similar concerns in response to the 2006 Regulation SHO Proposed Amendments. *See, e.g.,* letter from Congressman Tom Feeney—Florida, U.S. House of Representatives, dated Sept. 25, 2006 (''Feeney''); *see also* letter from Zix Corporation, dated Sept. 19, 2006 (''Zix'') (stating that ''[m]any investors attribute the Company's frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company ''do something'' about the perceived manipulative short selling. This perception that manipulative short selling of the Company's securities is continually occurring has undermined the confidence of many of the Company's investors in the integrity of the market for the Company's securities.'').

[29] Due in part to such concerns, some issuers have taken actions to attempt to make transfer of their securities ''custody only,'' (*i.e.,* certificating the securities and prohibiting ownership by a securities intermediary) thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company (''DTC'') or broker-dealers. *See* Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, at 62975 (Nov. 6, 2003). Some issuers have attempted to withdraw their issued securities on deposit at DTC in order to make the securities ineligible for book-entry transfer at a securities depository. *See id.* Withdrawing securities from DTC or requiring custody-only transfers would undermine the goal of a national clearance and settlement system designed to reduce the physical movement of certificates in the trading markets. *See id.* We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC. *See* Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

[30] *See* 2006 Regulation SHO Proposed Amendments, 71 FR 41712; 2007 Regulation SHO Final Amendments, 72 FR 45545; 2007 Regulation SHO Proposed Amendments, 72 FR 45558–45559; Anti-Fraud Rule Proposing Release, 73 FR 15378; Rule 204T Adopting Release, 73 FR 61709–61710 (providing discussion of the impact of fails to deliver on the market); *see also* 2003 Regulation SHO Proposing Release, 68 FR 62975 (Nov. 6, 2003) (discussing the impact of ''naked'' short selling on the market).

[31] According to the National Securities Clearing Corporation (''NSCC''), 99% (by dollar value) of all trades settle within T+3. Thus, on an average day, only approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle on time.

[32] 17 CFR 242.200. Regulation SHO became effective on January 3, 2005.

[33] 17 CFR 242.203(b)(1). Rule 203(b)(1) of Regulation SHO requires that, ''A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) Documented compliance with this paragraph (b)(1).'' This is known as the ''locate'' requirement. Market makers engaged in bona fide market making in the security at the time they effect the short sale are excepted from this requirement. In connection with this ''locate'' requirement, as well as other provisions of Regulation SHO that require a reasonableness determination (*i.e.,* Rules 200(g)(1) and 203(a)(2)(ii)), we remind any broker-dealer subject to such provisions that they have an affirmative obligation to obtain and consider information from their own records and/or from the records of another source helpful to making the reasonableness determinations required by such rules. Such information may include, but is not limited to, information regarding a customer's prior assurances regarding a locate source, its share ownership, or delivery of shares by settlement date. *See* 17 CFR 242.203(b)(1), 242.200(g)(1), 203(a)(2)(ii). *See also* 2004 Regulation SHO Adopting Release, 69 FR 48014, n. 58, 48019 at n. 111.

[34] For purposes of Regulation SHO, the term ''participant'' has the same meaning as in section 3(a)(24) of the Exchange Act. *See* 15 U.S.C. 78c(a)(24).

[35] The term ''registered clearing agency'' means a clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to Section 17A of the Exchange Act. *See* 15 U.S.C. 78c(a)(23)(A) and 78q–1, respectively; *see also* 2004 Regulation SHO Adopting Release, 69 FR 48031. The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter market. NSCC clears and settles trades through the Continuous Net Settlement (''CNS'') system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the contraparty to both sides of the transaction. We intend to closely monitor fails to deliver resulting from trades that are not cleared and settled through the CNS system.

[36] Rule 203(c)(6) of Regulation SHO defines a ''threshold security'' as any equity security of an issuer that is registered pursuant to Section 12 of the Exchange Act (15 U.S.C. 78*l*) or for which the issuer is required to file reports pursuant to Section 15(d) of the Exchange Act (15 U.S.C. 78o(d)) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more, and that is equal to at least 0.5% of the issue's total shares outstanding; and is included on a list disseminated to its members by a self-regulatory organization (''SRO''). *See* 17 CFR 242.203(c)(6).

[37] *See* 17 CFR 242.203(b)(3)(iv).

Due to our concerns about the potentially negative market impact of large and persistent fails to deliver, and the fact that we continued to observe threshold securities with fail to deliver positions that were not being closed out under existing delivery and settlement requirements, effective on October 15, 2007, we adopted an amendment to Regulation SHO that eliminated the ''grandfather'' provision.[38]

The options market maker exception excepted any fail to deliver position in a threshold security resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a threshold security. On September 17, 2008, we adopted and made immediately effective, as an emergency rule, an amendment to Rule 203(b)(3) of Regulation SHO to eliminate the options market maker exception to the rule's close-out requirement.[39] Following the issuance of the September Emergency Order, we adopted amendments making permanent the elimination of the options market maker exception.[40] As we discussed in the 2008 Regulation SHO Final Amendments, we believed it was appropriate to eliminate the options market maker exception in part because substantial levels of fails to deliver continued to persist in threshold securities and it appeared that a significant number of these fails to deliver were as a result of the options market maker exception.[41]

In adopting temporary Rule 204T of Regulation SHO pursuant to the September Emergency Order and subsequently pursuant to the Rule 204T Adopting Release, we strengthened further the close-out requirements of Regulation SHO by applying close-out requirements to fails to deliver resulting from sales of all equity securities and reducing the time-frame within which fails to deliver must be closed out.[42]

As noted above, since the adoption of temporary Rule 204T and the elimination of Regulation SHO's options market maker exception, we have seen a significant reduction in the number of fails to deliver in all equity securities. To continue advancing our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling, we are adopting the substance of temporary Rule 204T in a permanent rule, Rule 204. We continue to believe that strengthening the close-out requirements of Regulation SHO will further help to protect and enhance the operation, integrity, and stability of the markets, as well as help reduce potential short selling abuses.

III. Discussion of Rule 204 of Regulation SHO

As discussed in more detail below, we are maintaining the structure of temporary Rule 204T with limited modifications to address commenters' concerns. In discussing the provisions of Rule 204, we highlight below some of the main issues, concerns, and suggestions raised by commenters.[43]

A. Rule 204's Close-Out Requirement

1. Close-Out Period

In Rule 204(a), we are adopting the close-out requirements of temporary Rule 204T(a) without modification. Temporary Rule 204T(a) provides that a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours[44] on the settlement day[45] following the settlement date (*i.e.,* T+4), immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.[46]

Under certain circumstances, temporary Rule 204T provides additional time during which fails to deliver may be closed out. Specifically, temporary Rule 204T(a)(1) and (a)(3) provide that, subject to certain conditions, fails to deliver resulting from long sales or certain bona fide market making activity must be closed out by no later than the beginning of regular trading hours on the third settlement day after settlement date (*i.e.,* T+6).[47]

In response to our requests for comment, a number of commenters expressed concerns regarding the time periods within which fails to deliver must be closed out under temporary Rule 204T. Commenters expressed concern that temporary Rule 204T's

[38] *See* 2007 Regulation SHO Final Amendments, 72 FR 45544. This amendment also contained a one-time phase-in period that provided that previously-grandfathered fails to deliver in a security that was a threshold security on the effective date of the amendment must be closed out within 35 consecutive settlement days from the effective date of the amendment. The phase-in period ended on December 5, 2007.

[39] *See* Exchange Act Release No. 58572 (Sept. 17, 2008), 73 FR 54875 (Sept. 23, 2008) (''September Emergency Order'').

[40] *See* Exchange Act Release No. 58775 (Oct. 14, 2008), 73 FR 61690 (Oct. 17, 2008) (''2008 Regulation SHO Final Amendments''); *see also* 2007 Regulation SHO Proposed Amendments, 72 FR 45558; 2006 Regulation SHO Proposed Amendments, 71 FR 41710; Exchange Act Release No. 58107 (July 7, 2008), 73 FR 40201 (July 14, 2008) (''2008 Regulation SHO Re-Opening Release'').

[41] *See* 2008 Regulation SHO Final Amendments, 73 FR 61690; *see also* 2008 Regulation SHO Re-Opening Release, 73 FR 40201.

[42] In addition to these amendments to Regulation SHO, recently we have taken other actions aimed at reducing fails to deliver and addressing potentially abusive ''naked'' short selling. For example, in July 2008, we published an emergency order under section 12(k) of the Exchange Act (the ''July Emergency Order'') that temporarily restricted ''naked'' short selling in the publicly traded securities of nineteen financial institutions. *See* Exchange Act Release No. 58166 (July 15, 2008), 73 FR 55169 (July 21, 2008) (imposing borrowing and delivery requirements on short sales of the equity securities of nineteen financial companies); *see also* Exchange Act Release No. 58248 (July 29, 2008), 73 FR 45257 (Aug. 4, 2008) (extending the July Emergency Order such that it expired on August 12, 2008). In September 2008, we published an emergency order that temporarily banned short selling in the publicly traded securities of approximately 1,000 financial institutions (the ''Short Sale Ban''). *See* Exchange Act Release No. 58592 (Sept. 18, 2008), 73 FR 55169 (Sept. 24, 2008); *see also* Exchange Act Release No. 58611 (Sept. 21, 2008), 73 FR 55556 (Sept. 25, 2008) (amending the Short Sale Ban). The Short Sale Ban expired on October 8, 2008. In addition, in the September Emergency Order, we adopted and made immediately effective a ''naked'' short selling anti-fraud rule, Rule 10b–21, aimed at sellers, including broker-dealers acting for their own accounts, who deceive certain specified persons about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement date. *See* September Emergency Order. Following the issuance of the September Emergency Order, we adopted final amendments making Rule 10b–21 permanent. *See* Anti-Fraud Rule Adopting Release, 73 FR 61666; *see also* Anti-Fraud Rule Proposing Release, 73 FR 15376. In addition, on April 8, 2009, we proposed amendments to Regulation SHO that, if adopted, would add a short sale price test restriction or short sale circuit breaker rule to Regulation SHO. *See* Exchange Act Release No. 59748 (Apr. 10, 2009), 74 FR 18042 (Apr. 20, 2009) (the ''Short Sale Price Test Proposing Release'').

[43] *See supra* note 12.

[44] ''Regular trading hours'' has the same meaning as in Rule 600(b)(64) of Regulation NMS. Rule 600(b)(64) provides that ''*Regular trading hours* means the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to § 242.605(a)(2).''

[45] The term ''settlement day'' is defined in Rule 203(c)(5) of Regulation SHO as: ''* * * any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.'' 17 CFR 242.203(c)(5).

[46] *See* temporary Rule 204T(a).

[47] In addition, temporary Rule 204T(a)(2) provides that fails to deliver resulting from sales of securities pursuant to Rule 144 of the Securities Act of 1933 (''Rule 144 Securities'') must be closed out by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following settlement date (*i.e.,* T+39).

requirement to close-out fails to deliver by no later than the beginning of regular trading hours can create buying pressure at the open, that may temporarily distort the price of the security.[48] To minimize the market impact of the close-out requirement, commenters suggested allowing participants to close out fails to deliver by the end of regular trading hours, or the close of business on the New York Stock Exchange (''NYSE''), rather than by no later than the beginning of regular trading hours.[49] In requesting additional time during the day to close out fails to deliver, one commenter noted that such a change ''would significantly alleviate the market pressures associated with execution of potentially large purchases at the opening of trading—a time when markets are particularly susceptible to price fluctuations.'' [50] This commenter also stated that, as a practical matter, ''transactions effected at market open to close-out open fail positions are no different from those effected later on in the trading session because both are part of the same clearance and settlement cycle. Thus, providing this relief would not add any delay of consequence to the close-out process.'' [51]

Other commenters requested additional days within which to close out fails to deliver in connection with short sales. For example, some commenters requested that the Commission extend the close-out period for fails to deliver resulting from short sales to three settlement days after the fail occurs, consistent with the close-out period for fails to deliver resulting from long sales and market making activity.[52] Other commenters requested that the Commission extend the close-out requirement for fails to deliver resulting from all sales to five settlement days after the fail to deliver position occurs.[53] These commenters stated that the additional time to close out fails to deliver would allow the majority of trades to clear and settle on their own within a few days following the regular settlement date (*i.e,* T+3).[54]

Some commenters expressed concerns about the effect of the close-out requirements of temporary Rule 204T on securities lending.[55] For example, one commenter stated that the compressed time-frame for closing out fails to deliver under temporary Rule 204T ''has generated over-buying and borrowing of securities that would otherwise settle in the normal course, thus impairing liquidity by tying up shares that would otherwise be available to natural buyers and sellers.'' [56] This commenter also noted that in practice fails to deliver resulting from sales of securities on loan, which are considered ''long'' sales, are often closed out in accordance with the time-frames for fails to deliver resulting from short sales rather than long sales because temporary Rule 204T does not provide sufficient time to determine whether or not a fail to deliver position resulted from a long or short sale.[57] According to this commenter, such purchasing activity acts as a disincentive to lending and causes institutions to question their participation in lending programs.[58]

Other commenters stated that where the holder of a long position sells securities that have been financed through a securities loan, the close-out requirements of temporary Rule 204T may not provide sufficient time for the securities to be recalled and delivered in time for settlement of the sale transaction.[59] These commenters stated, among other things, that temporary Rule 204T's requirement that securities be delivered by no later than the beginning of regular trading hours does not allow for the completion of the securities lending cycle, which may not occur until the close of the DTC settlement window on the third settlement day after settlement date (*i.e.,* T+6).[60]

As noted above, the close-out requirements of temporary Rule 204T are advancing our goal of further reducing fails to deliver, as evidenced in part by preliminary results from OEA regarding its impact on the number of fails to deliver.[61] Thus, we are adopting as a permanent rule the structure of the close-out requirements of temporary Rule 204T. Specifically, Rule 204(a) provides that a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours [62] on the settlement day [63]

[48] *See, e.g.,* letter from Stuart Kaswell, Executive Vice President and General Counsel, Managed Funds Association, dated Dec. 15, 2008 (''MFA''); letter from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, dated Dec. 23, 2008 (''CBOE''); letter from Amal Aly, Managing Director and Associate General Counsel, SIFMA, dated Dec. 16, 2008 (''SIFMA''); letter from Eric Swanson, General Counsel, BATS Exchange, Inc., dated Dec. 29, 2008 (''BATS''); letter from Michael P. McAuley, Chair, RMA Committee on Securities Lending, dated Dec. 23, 2008 (''RMA''); letter from Stefan Gavell, Executive Vice President and Head of Regulatory Industry Affairs, State Street Corporation, dated Dec. 16, 2008 (''State Street'').

[49] *See, e.g.,* letters from SIFMA; MFA; State Street; BATS; letter from A. Peter Allman-Ward, Executive Vice President and CFO, Wedbush Morgan Securities, Inc., dated Dec. 15, 2008 (''Wedbush'').

[50] Letter from SIFMA.

[51] *See id.*

[52] *See e.g.,* letter from Peter Kovac, Chief Operating Officer and Financial and Operations Principal, EWT, LLC, dated Nov. 25, 2008 (''EWT''); letter from James S. Chanos, Chairman, Coalition of Private Investment Companies, dated Dec. 16, 2008 (''Coalition of Private Investment Companies''); letters from SIFMA; MFA; State Street.

[53] *See, e.g.,* letter CBOE; letter from Boston Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Alternext US, NYSE Arca, and The Options Clearing Corporation, dated Dec. 19, 2008 (''Options Exchanges'').

[54] *See, e.g.,* letters from SIFMA; MFA; State Street; CBOE; Options Exchanges; Coalition of Private Investment Companies.

[55] As stated in the Rule 204T Adopting Release, if a person that has loaned a security to another person sells the security and a bona fide recall of the security is initiated within two business days after trade date, the person that has loaned the security will be ''deemed to own'' the security for purposes of Rule 200(g)(1) of Regulation SHO, and such sale will not be treated as a short sale for purposes of temporary Rule 204T. In addition, a broker-dealer may mark such orders as ''long'' sales provided such marking is also in compliance with Rule 200(c) of Regulation SHO. *See* Rule 204T Adopting Release, 73 FR 61713, n. 70.

[56] Letter from SIFMA.

[57] *See* letter from SIFMA; *see also* letter from RMA; letter from Heather Traeger, Assistant Counsel, Investment Company Institute, dated Dec. 16, 2008 (''ICI'').

[58] *See* letter from SIFMA; *see also* letter from RMA (recommending the extension of the close-out period for fails to deliver for all sales to settlement date plus three days (*i.e.,* T+6) ''to ensure that beneficial owners selling on-loan positions are not compromised by close-outs of long sales on T+4'').

[59] *See* letters from EWT; BATS; RMA; ICI; Wedbush.

[60] *See* letters from EWT; BATS; RMA; ICI. EWT stated that a recall typically occurs to assure that the securities are returned on the settlement date for the sale transaction. If the securities are not returned by that date, the lender may initiate a buy-in process designed to obtain the securities as promptly as possible. This buy-in is intended to result in delivery of the securities after three business days, such that the lender will not complete the buy-in process until the close of the DTC settlement window on the third business day following initiation of the buy-in process. Accordingly, this commenter recommended, among other things, that we should: (1) either (a) create an exception for fails to deliver where the securities are loaned but have been recalled or (b) confirm that the issuance of a bona fide loan recall notice is a valid form of close-out for a fail to deliver; or (2) extend the close-out period from settlement date plus three days (*i.e.,* T+6), to settlement date plus six days (*i.e.,* T+9) for fails to deliver resulting from long sales. *See also* letter from RMA (stating that due to operational complexity and the number of market participants involved in the sale of an ''on-loan position,'' it is commonplace for a sale to be settled during the day on T+6).

[61] *See supra* note 8, and accompanying text.

[62] *See supra* note 44 (discussing the definition of the term ''regular trading hours'' for purposes of Regulation SHO).

[63] *See supra* note 45 (discussing the definition of the term ''settlement day'' for purposes of Regulation SHO).

following the settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.[64]

In addition, as discussed in more detail below, we are adopting in Rule 204(a)(1) and (a)(3) the close-out requirements of temporary Rule 204T(a)(1) and (a)(3) for fails to deliver resulting from long sales and certain bona fide market making activity so that such fails to deliver must be closed out by no later than the beginning of regular trading hours on the close-out date (*i.e.,* T+6) for such fails to deliver.[65]

Although we recognize commenters' concerns regarding the potential market impact of the close-out requirements of temporary Rule 204T, particularly at the market open, we believe that these potential effects are justified by the benefits of retaining the strict close-out requirements of temporary Rule 204T. As discussed above, since the adoption of temporary Rule 204T, and other actions taken by the Commission aimed at reducing fails to deliver, there has been a significant reduction in fails to deliver. To maintain these declines, we believe it is necessary at this time to continue to require that participants close out fails to deliver by no later than the beginning of regular trading hours on the applicable close-out date. We believe that the strict close-out requirements of the temporary rule have helped reduce fails to deliver by providing a disincentive to those who, but for the rule, may have failed to deliver securities by settlement date. In addition, we note that participants have been operating pursuant to the close-out requirements of the temporary rule, as adopted, and appear to have adjusted to its requirements.[66]

We believe that continuing to require that fails to deliver be closed out on the day immediately following the day on which the fail to deliver occurs is consistent with our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing ''naked'' short selling and, in particular, potentially abusive ''naked'' short selling. Although extending the time-frames within which fails to deliver must be closed out may allow for ordinary course settlement, as several commenters contend, we believe that the close-out requirements of Rule 204 are necessary to continue to help encourage delivery by settlement date and achieve our goal of not allowing fails to deliver to persist.[67]

As we discussed in the Rule 204T Adopting Release, we believe that delivery on sales should be made by settlement date.[68] In the Rule 204T Adopting Release, we noted that the vast majority of fails to deliver are closed out within five days after T+3.[69] In addition, in that release we referenced a recent analysis by OEA that found that more than half of all fails to deliver and more than 70% of all fail to deliver positions are closed out within two settlement days after T+3.[70] We also noted in that release, however, that although this information shows that delivery is being made, it demonstrates that often delivery is not being made until several days following the standard three-day settlement cycle.

In addition, as discussed above, fails to deliver may be part of a scheme to manipulate the price of a security. We are also concerned about the negative effect that fails to deliver and potentially abusive ''naked'' short selling may have on the market and the broader economy, including on investor confidence.[71] The close-out requirements of Rule 204 help address these concerns by prohibiting the persistence of fails to deliver.

We understand, however, that fails to deliver may occur from long sales within the first two settlement days after settlement date for legitimate reasons.[72] For example, human or mechanical errors or processing delays can result from transferring securities in custodial or other form rather than book-entry form, thereby causing a fail to deliver on a long sale.[73]

Thus, in Rule 204(a)(1), we are adopting, with certain limited modifications, the provisions of temporary Rule 204T(a)(1) relating to closing out fails to deliver resulting from long sales. Specifically, Rule 204(a)(1) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security and the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date immediately close out the fail to deliver position by purchasing or borrowing securities of like kind and quantity.[74]

In response to a request for comment, some commenters requested that we provide additional flexibility to the close-out requirements of temporary Rule 204T(a)(1) by allowing participants to borrow as well as purchase securities to close out such fails to deliver.[75] In temporary Rule 204T(a)(1), we required a participant to purchase securities to close out fails to deliver resulting from long sales to be consistent with the close-out requirements of Rule 203(b)(3) of Regulation SHO which require that a participant that has a fail to deliver position in a threshold security for thirteen consecutive settlement days immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity.[76]

[64] *See* Rule 204(a).

[65] In addition, as discussed in Section III.E. below, we are adopting the close-out requirements of Rule 204(a)(2) for fails to deliver resulting from sales of Rule 144 Securities so that such fails to deliver must be closed out by no later than the beginning of regular trading hours on the applicable close-out date.

[66] In discussing the requirement to purchase securities by no later than the beginning of regular trading hours on the applicable close-out date, some commenters discussed the ability to use, among other mechanisms, volume weighted average price (''VWAP'') orders entered at the beginning of the day to more effectively manage their buy-in risk. *See, e.g.,* letters from Duncan L. Niederaurer, CEO, NYSE Euronext and Richard G. Ketchum, NYSE Regulation, Inc., dated Dec. 16, 2008 (''NYSE''); ICI. We note that if a participant has a fail to deliver position at a registered clearing agency that it must close out in accordance with Rule 204 of Regulation SHO, the participant may satisfy the close-out requirement to purchase securities of like kind and quantity with a VWAP order provided: (i) the order to purchase the equity security on a VWAP basis is irrevocable and received by no later than the beginning of regular trading hours on the applicable close-out date; and (ii) the final execution price of any such transaction is not determined until after the close of regular trading hours when the VWAP value is calculated and the execution is on an agency basis.

[67] *See supra* note 16 (discussing the standard three-day settlement cycle).

[68] *See* Rule 204T Adopting Release, 73 FR 61712–61713.

[69] *See id.*

[70] *See id.* at n. 68. We note that OEA's analysis examined the period from January to July 2008 and used the age of the fail to deliver position as reported by the NSCC. The NSCC data included only securities with at least 10,000 shares in fails to deliver. These numbers also included securities that were not subject to the close-out requirement in Rule 203(b)(3) of Regulation SHO, which applies only to ''threshold securities'' as defined in Rule 203(c)(6) of Regulation SHO.

[71] *See, e.g.,* Anti-Fraud Rule Adopting Release, 73 FR 61666.

[72] *See* Rule 204T Adopting Release, 73 FR 61713.

[73] *See id.*

[74] *See* Rule 204(a)(1).

[75] *See e.g.,* letters from SIFMA; EWT; MFA; State Street; BATS; Wedbush; Angel.

[76] *See* 17 CFR 242.203(b)(3). Some commenters requested clarification regarding a broker-dealer's obligations under FINRA Rule 11810 (the ''FINRA Buy-In Rule'') and the close-out requirements of temporary Rule 204T. *See, e.g.,* letter from Joseph Zangri, Chief Compliance Officer, Bloomberg Tradebook, LLC (Dec. 16, 2008) (''Bloomberg''). We note that because the requirements of Rule 204 apply to broker-dealers involved in the sell-side of a transaction, whereas the FINRA Buy-In Rule sets forth procedures applicable to a purchaser that chooses to buy-in a seller, we believe that these rules apply separate and distinct obligations on

Continued

Commenters stated that borrowing securities serves the same purpose as purchasing securities to close out fails to deliver.[77] In addition, commenters noted that allowing a borrow to close out such fails would be consistent with the close-out requirements for short sales. After considering the comments received, we provide in Rule 204(a)(1) the ability for a participant to close out a fail to deliver position resulting from a long sale by purchasing or borrowing securities.[78] We believe that such an amendment is consistent with our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, because it will provide additional flexibility to participants in closing out fail to deliver positions.[79] Permitting a borrow as well as a purchase will also make the close-out requirements of Rule 204(a)(1) consistent with the close-out requirements of Rule 204(a).

As we stated with respect to Rule 204T's close-out requirements, under Rule 204's close-out requirements for fails to deliver resulting from long or short sales, a participant must take affirmative action to close out a fail to deliver position by purchasing or borrowing securities.[80] Thus, a participant may not offset the amount of its fail to deliver position with shares that the participant receives or will receive during the applicable close-out date (*i.e.*, during T+4 or T+6, as applicable).[81] In addition, as we stated in the Rule 204T Adopting Release, to meet its close-out obligation a participant also must be able to demonstrate on its books and records that on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position and, therefore, that the participant has a net flat or net long position on its books and records on the applicable close-out date (*i.e.,* during T+4 or T+6, as applicable).[82]

Consistent with temporary Rule 204T, Rule 204 defines a ''settlement date'' as ''the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.'' [83] As we noted in the Rule 204T Adopting Release, this definition is consistent with Rule 15c6–1 under the Exchange Act that prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction.[84]

Because most transactions settle by T+3 and because delivery on all sales should be made by settlement date, participants should consider having in place policies and procedures to help ensure that delivery is being made by settlement date. As we stated in the Rule 204T Adopting Release, we intend to examine participants' policies and procedures to determine whether, among other things, such policies and procedures require broker-dealers to monitor for delivery by settlement date.[85]

Consistent with the existing close-out requirements of Rule 203(b)(3) of Regulation SHO and temporary Rule 204T, the close-out requirements of Rule 204 are based on a participant's fail to deliver position at a registered clearing agency. As noted above, the NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter markets. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. Because Rule 204 is based on a participant's fail to deliver position at a registered clearing agency, it is consistent with current settlement practices and procedures and with the Regulation SHO framework regarding delivery of securities.[86]

2. Application to All Equity Securities

Consistent with temporary Rule 204T, the close-out requirements of Rule 204 apply to fails to deliver in all equity securities. As discussed in the Rule 204T Adopting Release, this requirement differs from the close-out requirement of Rule 203(b)(3) of Regulation SHO that applies the close-out requirements of that rule only to those securities with a large and persistent level of fails to deliver, *i.e.*, threshold securities.[87]

A purpose of Rule 204 is to help limit the use of ''naked'' short selling as part of a manipulative scheme. To achieve this purpose, we are applying the rule to all equity securities, regardless of the level or persistence of any fails to deliver in such securities. In addition, as discussed above, we believe that all sellers of equity securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. We believe this should be the case for sales in all equity securities and are adopting this rule to further that goal.

We note that in the Rule 204T Adopting Release, we requested comment regarding whether temporary Rule 204T should be expanded to apply to debt as well as equity securities. In response, commenters opposed the extension of temporary Rule 204T to debt securities.[88] One such commenter stated that the Commission has expressly carved out debt securities from all short sale regulations, including Regulation SHO, citing in support the non-manipulative potential associated

market participants and, therefore, are not in conflict.

[77] *See e.g.,* letter from MFA.

[78] *See* Rule 204(a)(1). Although Rule 204(a)(1) permits borrowing to close out a fail to deliver position resulting from a long sale, broker-dealers must also comply with Rule 203(a) of Regulation SHO. Rule 203(a)(1) provides that, unless an exception applies, ''[i]f a broker or dealer knows or has reasonable grounds to believe that the sale of an equity security was or will be effected pursuant to an order marked ''long,'' such broker or dealer shall not lend or arrange for the loan of any security for delivery to the purchaser's broker after the sale, or fail to deliver a security on the date delivery is due.'' 17 CFR 242.203(a).

[79] *See* letter from CBOE (stating that the close-out procedures under temporary Rule 204T for fails to deliver attributable to bona fide market making activity should be amended to permit borrows or purchases throughout the close-out period).

[80] *See* Rule 204T Adopting Release, 73 FR 61710.

[81] In determining its close-out obligation, a participant may rely on its net delivery obligation as reflected in its notification from NSCC regarding its securities delivery and payment obligations, provided such notification is received prior to the beginning of regular trading hours on the applicable close-out date. *See* Rule 204T Adopting Release, 73 FR 61711, at n. 46 (and accompanying text).

[82] *See* Rule 204T Adopting Release, 73 FR 61711. Both temporary Rule 204T and Rule 204 require that a participant purchase or borrow shares, as applicable, to close out a fail to deliver position. Accordingly, the purchase or borrow on the applicable close-out date must be for the full quantity of the fail to deliver position that is subject to the close-out requirement. In addition, where a participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement.

[83] *See* Rule 204(g)(1); *see also* Rule 204T(f)(1).

[84] *See* 17 CFR 240.15c6–1; *see also* Rule 204T Adopting Release, 73 FR 61711.

[85] *See* Rule 204T Adopting Release, 73 FR 61711. Of course, broker-dealers must comply with any applicable SRO policies and procedures requirements. For example, NASD Rule 3010 contains, among other things, written procedures requirements for member firms.

[86] *See* temporary Rule 204T; *see also* 17 CFR 242.203(b)(3).

[87] *See* Rule 204T Adopting Release, 73 FR 61711; *see also* 17 CFR 242.203(b)(3).

[88] *See, e.g.,* letters from SIFMA; MFA; State Street.

with fixed income securities.[89] This commenter stated that it believes that certain structured products should also be excluded from the application of temporary Rule 204T.[90] This commenter acknowledged, however, that the ''equity'' status of some structured products may not be clear and its view that it may not be feasible for the Commission to make broad-based determinations on whether categories of securities constitute debt or equity.[91]

After considering the comments and because all other provisions of Regulation SHO apply only to equity securities, at this time, we are not extending Rule 204 to securities other than equity securities. We note, however, for those securities for which market participants believe the ''equity'' status is unclear, we will consider on a case-by-case basis whether the provisions of Rule 204, and Regulation SHO more generally, apply.

Regulation SHO, as adopted in 2004, was a first step in reducing persistent fails to deliver and addressing abusive ''naked'' short selling. In Regulation SHO, we took a targeted approach, imposing additional delivery requirements on securities with a substantial and persistent amount of fails to deliver. As we stated in the 2004 Regulation SHO Adopting Release, we took this targeted approach at that time in an effort to address the problem but at the same time not to burden the vast majority of securities where there are not similar concerns regarding settlement.[92] In addition, Regulation SHO's close-out requirement was adopted to address potential abuses that may occur with large, extended fails to deliver.[93] We also noted in the 2004 Regulation SHO Adopting Release, however, that we would pay close attention to the operation and efficacy of the provisions we were adopting at that time and would consider whether any further action was warranted.[94]

Because of continued concerns about the potentially negative market impact of fails to deliver, and the fact that through our monitoring of the efficacy of Regulation SHO's close-out requirement we continued to observe threshold securities with fail to deliver positions that were not being closed out, we eliminated the ''grandfather'' and options market maker exceptions to Regulation SHO's close-out requirements.[95]

However, as we stated in the Rule 204T Adopting Release, we were concerned that the close-out requirements of Regulation SHO, as adopted, had not gone far enough in reducing fails to deliver and addressing potentially abusive ''naked'' short selling.[96] In light of the recent instability and lack of investor confidence in the financial markets,[97] we believe that the requirements of temporary Rule 204T should be made permanent to maintain the reduced fails to deliver and to address potentially abusive ''naked'' short selling.

We note that one commenter to the Rule 204T Adopting Release suggested eliminating temporary Rule 204T of Regulation SHO, such that only the close-out requirements of Rule 203(b)(3) would apply.[98] If we were to take such an approach, Regulation SHO's close-out requirements would apply only to threshold securities and fails to deliver in such securities would not have to be closed out until such fails to deliver had persisted for thirteen consecutive settlement days. As discussed above, we are applying the close-out requirements of Rule 204 to all equity securities to further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, in both threshold and non-threshold securities and, thereby, also help continue to address abusive ''naked'' short selling in such securities. In the Rule 204T Adopting Release, we noted that prior to its adoption, fails to deliver in non-threshold securities averaged approximately 624 million shares or $4.6 billion in value per day from January to July 2008.[99] Since adoption of the temporary rule, and in connection with other Commission actions to address fails to deliver, this number has declined significantly such that from December 2008 to March 2009, OEA estimates that fails to deliver in non-threshold securities averaged approximately 307 million shares or $1.1 billion in value per day. We are applying Rule 204's close-out requirements to all equity securities to help maintain the benefits already achieved.

3. Allocation of a Fail To Deliver Position

Temporary Rule 204T(d) provides that a participant may reasonably allocate its responsibility to close out a fail to deliver position to another broker-dealer from which the participant receives trades for clearance and settlement.[100] Consistent with temporary Rule 204T(d), Rule 204(d) provides for allocation of a fail to deliver position by a participant to a broker-dealer. Specifically, Rule 204(d) provides that if a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or from which it receives trades for settlement, based on such broker's or dealer's short position, the provisions of Rule 204(a) and (b) relating to such fail to deliver position shall apply to such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.[101]

Thus, participants that are able to identify the accounts of broker-dealers for which they clear or from which they receive trades for settlement may allocate the responsibility to close out the fail to deliver position to the particular broker-dealer account(s) whose trading activities have caused the fail to deliver position provided the allocation is reasonable (*e.g.*, the allocation must be timely). Absent such identification, however, the participant would remain subject to the close-out requirement.[102]

[89] *See* letter from SIFMA (referring to, among other things, Securities Exchange Act Release No. 56206 (Aug. 6, 2007), 72 FR 45094 (Aug. 10, 2007)).

[90] *See id.*

[91] *See id.*

[92] *See* 2004 Regulation SHO Adopting Release, 69 FR 48016.

[93] *See id.* at 48017.

[94] *See id.* at 48018.

[95] *See supra* Section II (discussing the elimination of Regulation SHO's ''grandfather'' and options market maker exceptions).

[96] *See* Rule 204T Adopting Release, 73 FR 61711–61712.

[97] *See, e.g.,* letter from Leland Chan, General Counsel, California Bankers Association, dated Aug. 21, 2008; letter from Eric C. Jensen, Esq., Cooley Godward Kronish L.L.P., dated Aug. 21, 2008; letter from Steven B. Boehm and Cynthia M. Krus, Sutherland Asbill Brennan LLP, dated July 31, 2008; letter from James J. Angel, Professor of Finance, Georgetown University, McDonough School of Business, dated Aug. 20, 2008; letter from Tuan Nguyen, dated Aug. 8, 2008; *see also* Short Sale Price Test Proposing Release, 74 FR 18042 (proposing short sale price test restrictions and short sale circuit breaker rules due to recent changes in market conditions and a deterioration in investor confidence).

[98] *See* letter from CBOE.

[99] *See* Rule 204T Adopting Release, 73 FR 61712, n. 60. We also noted these fails accounted for approximately 54.5% (56.6%) of all fail to deliver shares (by dollar value).

[100] *See* temporary Rule 204T(d); *see also* 17 CFR 242.203(b)(3)(vi). Rule 203(b)(3)(vi) of Regulation SHO provides that ''[i]f a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this paragraph (b)(3) relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.''

[101] *See* Rule 204(d).

[102] One commenter requested that we clarify whether an allocated broker-dealer may reasonably re-allocate to the broker-dealer from which it

Continued

If a participant allocates a fail to deliver position to a broker-dealer in accordance with Rule 204(d), such that the close-out requirements of Rule 204(a) apply to that broker-dealer, the broker-dealer to which the position was allocated must be able to demonstrate that on the applicable close-out date, it purchased or borrowed shares in the full quantity of the fail to deliver position allocated to it, and that it has a net flat or net long position on its books and records for that security on the applicable close-out date.[103]

In addition, as discussed above and consistent with temporary Rule 204T, the close-out requirements of Rule 204 require that the allocated broker-dealer take affirmative action to close out the fail to deliver position by purchasing or borrowing securities. Thus, a broker-dealer allocated a fail to deliver position may not offset the amount of its fail to deliver position with shares that the broker-dealer receives or will receive during the applicable close-out date (*i.e.,* during T+4 or T+6, as applicable).[104]

Temporary Rule 204T(d) imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements. Specifically, temporary Rule 204T(d) provides that a broker-dealer that has been allocated a portion of a fail to deliver position that does not comply with the provisions of temporary Rule 204T(a) must immediately notify the participant that it has become subject to the borrowing requirements of temporary Rule 204T(b).[105] In the Rule 204T Adopting Release, we stated that we adopted this notification requirement so that participants would know when a broker-dealer for which they clear and settle trades has become subject to the temporary rule's borrowing requirements.[106] We did not receive any comments specific to this notification requirement. We believe that the reasons for adopting this notification requirement in temporary Rule 204T(d) apply to Rule 204(d) as well. Thus, we have determined to maintain the requirement under Rule 204(d) that a broker-dealer that has been allocated a portion of a fail to deliver position that does not comply with the provisions of Rule 204(a) must immediately notify the participant that it has become subject to the borrowing requirements of Rule 204(b).[107]

B. Rule 204(b)—Borrowing Requirement

1. Borrowing Requirement

We are adopting in Rule 204(b) the requirements of temporary Rule 204T(b) without modification. If a participant does not purchase or borrow shares, as applicable, to close out a fail to deliver position in accordance with Rule 204, the participant violates the close-out requirement of the rule. Rule 204(b), like temporary Rule 204T(b), also imposes on the participant and on all broker-dealers from which that participant receives trades for clearance and settlement (including introducing and executing brokers), a requirement to borrow or arrange to borrow securities prior to accepting or effecting further short sales in that security. Specifically, Rule 204(b) provides that the participant and any broker-dealer from which it receives trades for clearance and settlement, including any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,[108] may not accept a short sale order in an equity security from another person, or effect a short sale order in such equity security for its own account, to the extent that the broker-dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security, or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.[109]

We believe it is appropriate to include in the rule borrow requirements for broker-dealers, including participants, that sell short a security for which a fail to deliver position has not been closed out in accordance with the requirements of the rule. We believe that the borrow requirements of Rule 204(b) will further our goal of limiting fails to deliver, thereby addressing abusive ''naked'' short selling by promoting the prompt and accurate clearance and settlement of securities transactions. By requiring that participants and broker-dealers from which they receive trades for clearance and settlement borrow or arrange to borrow securities prior to accepting or effecting short sales in the security that has a fail to deliver position that has not been closed out, the rule will help to ensure that shares will be available for delivery on the short sale by settlement date and, thereby, help to avoid additional fails to deliver occurring in the security.

One commenter asked for clarification regarding whether a participant ceases to be subject to the borrow requirements of temporary Rule 204T(b) if that participant no longer has a fail to deliver position at a registered clearing agency due the participant borrowing the securities or the participant receiving securities from the seller (*e.g.,* in connection with long sales).[110] Temporary Rule 204T(b) imposes short sale borrowing requirements until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency. Thus, under temporary Rule 204T regardless of whether a participant borrows or receives delivery of securities, the requirements of temporary Rule 204T(b) continue to apply until the participant purchases securities to close out the fail to deliver position and that purchase has cleared and settled at a registered clearing agency.

We have incorporated these same requirements into Rule 204(b) without modification. Rule 204(b) requires the purchase and clearance and settlement

received the trade all or a portion of the fail to deliver position that it was allocated. This commenter stated that such re-allocation may continue until the fail position is allocated to the ultimate initiating broker-dealer. *See* letter from Bloomberg. We note that Rule 204(d) applies only to the allocation by a participant to a registered broker or dealer for which it clears trades or from which it receives trades for settlement. Thus, if a participant allocates all or a portion of a fail to deliver position to a broker-dealer, the close-out requirements of Rule 204 will apply to that allocated broker-dealer. This is consistent with the allocation provisions of temporary Rule 204T and Rule 203(b)(3) of Regulation SHO. Rule 204 does not, by its terms, apply to the allocation of costs by a broker-dealer in connection with meeting its close-out requirements.

[103] *See* Rule 204(d); *see also supra* note 82.

[104] *See supra* note 81 and supporting text.

[105] *See* temporary Rule 204T(d).

[106] *See* Rule 204T Adopting Release, 73 FR 61711.

[107] *See* Rule 204(d).

[108] *See* 17 CFR 242.203(b)(2)(iii) (providing an exception from Regulation SHO's ''locate'' requirement for short sales effected by a market maker in connection with bona fide market making activities in the securities for which the exception is claimed).

[109] *See* Rule 204(b). The borrow requirements of Rule 204(b) are also consistent with the requirements of Rule 203(b)(3)(iv) of Regulation SHO for a participant that has not closed out a fail to deliver position in a threshold security that has persisted for thirteen consecutive settlement days. *See* 17 CFR 242.203(b)(3)(iv). Rule 203(b)(3)(iv) of Regulation SHO provides that ''[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, many not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity''.

[110] *See* letter from SIFMA.

of shares purchased to help ensure that the fail to deliver position is closed out before the participant, and broker-dealers from which they receive trades for clearance and settlement, can accept or effect additional short sales without first borrowing or arranging to borrow such securities. Moreover, the provisions of Rule 204(b) are intended to act as an additional incentive to broker-dealers to deliver securities by settlement date, and to close out fail to deliver positions in accordance with the requirements of Rule 204. We believe that these goals would not be furthered absent the purchase requirement of Rule 204(b).

As discussed above in Section III.A.3, Rule 204(d) provides that a participant may reasonably allocate (*e.g.,* the allocation must be timely) its responsibility to close out a fail to deliver position to another broker-dealer for which the participant clears or from which the participant receives trades for settlement. Thus, to the extent that the participant can identify the broker-dealer(s) that contributed to the fail to deliver position, and the participant has reasonably allocated the close-out obligation to the broker-dealer(s), the requirement to borrow or arrange to borrow prior to effecting further short sales in that security will apply to only those particular broker-dealer(s).

Rule 204(b), however, includes an exception from the borrowing requirements for any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. We have incorporated into Rule 204(b) the language of temporary Rule 204T(b)(1), without modification. Thus, Rule 204(b) provides that a broker-dealer shall not be subject to the requirements of paragraph (b) of Rule 204 if the broker-dealer timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that the broker-dealer is in compliance with the requirements of Rule 204(e).[111] We have included this exception because we do not believe that a broker-dealer should be subject to the borrowing requirements of the temporary rule if the broker-dealer can demonstrate that it did not incur a fail to deliver position in the security on settlement date, or if it has taken steps, in accordance with Rule 204(e), to close out the fail to deliver position.

2. Notification Requirement

In connection with the borrowing requirements of Rule 204(b), we are incorporating into Rule 204(c) the notification requirement contained in temporary Rule 204T(c), without modification. In accordance with Rule 204(c), participants must notify all broker-dealers from which they receive trades for clearance and settlement that a fail to deliver position has not been closed out in accordance with Rule 204. Specifically, Rule 204(c) provides that the participant must notify any broker-dealer from which it receives trades for clearance and settlement, including any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,[112] (a) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of Rule 204, and (b) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.[113]

We are including this notification requirement in Rule 204(c) so that all broker-dealers that submit trades for clearance and settlement to a participant that has a fail to deliver position in a security that has not been closed out in accordance with Rule 204 will be on notice that short sales in that security to be cleared or settled through that participant will be subject to the borrow requirements of Rule 204(b) until the fail to deliver position has been closed out, or unless the broker-dealer can demonstrate, as specified in Rule 204(b), that it is not responsible for the fail to deliver position.

C. Credit for Early Close-Outs

To encourage early close outs of fail to deliver positions, temporary Rule 204T(e) provides that a broker-dealer can satisfy the temporary rule's close-out requirement by purchasing securities in accordance with the conditions of that provision (*i.e.,* broker-dealers will receive ''pre-fail credit'' for the purchase).[114] Encouraging early close outs of fail to deliver positions advances our goal of reducing fails to deliver. Thus, we have incorporated the conditions of temporary Rule 204T(e) into Rule 204 with some limited modifications to address commenters' concerns and to provide clarification regarding the applicability of the conditions.

Specifically, Rule 204(e) provides that even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with Rule 204(a), or has not allocated a fail to deliver position to a broker-dealer in accordance with Rule 204(d), a broker-dealer shall not be subject to the requirements of Rule 204(a) or (b) if the broker-dealer purchases or borrows[115] the securities, and complies with the conditions set forth in Rule 204(e)(1) though (4), as described in more detail below.

One commenter requested that we allow a broker-dealer to borrow as well as purchase shares to obtain credit for closing out a position prior to the applicable close-out date.[116] Temporary Rule 204T(e) provides that a broker-dealer must purchase securities to obtain credit for closing out a position prior to the applicable close-out date because under Rule 203(b)(3) of Regulation SHO, we understand that broker-dealers purchased shares to obtain credit for closing out fails to deliver in threshold securities prior to the thirteenth consecutive settlement day of having a fail to deliver position in such security. We believe, however, that allowing a broker-dealer to borrow as well as purchase securities to obtain credit for early close-outs is consistent with our goal of maintaining the benefits already achieved under temporary Rule 204T, as well as other actions by the Commission, such as the recent reduction in fails to deliver, by providing broker-dealers with additional flexibility in closing out fails to deliver. We also note that allowing a borrow is consistent with the close-out requirements of Rule 204(a) which permit a participant to close out fails to deliver on the applicable close-out date by either borrowing or purchasing securities.[117]

Consistent with temporary Rule 204T(e)(1), to obtain pre-fail credit under Rule 204(e), the purchase or borrow must be ''bona fide.'' Thus, where a broker-dealer enters into an arrangement with another person to purchase or borrow securities, and the broker-dealer knows or has reason to know that the other person will not deliver securities in settlement of the

[111] *See* Rule 204(b). Rule 204(e) is discussed in detail below in Section III.C.

[112] *See supra* note 108.

[113] *See* Rule 204(c).

[114] *See* temporary Rule 204T(e).

[115] As discussed in more detail below, in contrast to temporary Rule 204T(e), Rule 204(e) permits a broker-dealer to borrow as well as purchase securities to close-out a fail to deliver position prior to the applicable close-out date.

[116] *See* letter from SIFMA.

[117] *See* Rule 204(a); *see also supra* Section III.A.1. (discussing the close-out requirements of Rule 204(a)).

transaction, the purchase or borrow will not be ''bona fide.'' [118]

Also consistent with temporary Rule 204T(e)(2), Rule 204(e)(2) provides that to obtain pre-fail credit, *i.e.,* credit for purchases or borrows to close out fails to deliver resulting from short sales, the purchase or borrow must be executed after trade date but by no later than the end of regular trading hours on settlement date (*i.e.,* T+3) for the transaction. Thus, the purchase or borrow must be executed on T+1, 2, or 3.

Temporary Rule 204T(e)(3) provides that the purchase must be of a quantity of securities sufficient to cover the entire amount of the broker-dealer's open short position. One commenter stated that it believes that the broker-dealer should only have to close out its open fail to deliver position, and not its open short position.[119] This commenter noted that a broker-dealer's open short position could far exceed its open fail to deliver position and, therefore, a requirement to purchase securities to close out the broker-dealer's entire open short position would not encourage early close outs of fail to deliver positions.[120]

The purpose of Rule 204(e) is to encourage broker-dealers to close out fail to deliver positions prior to the close-out date. Requiring a broker-dealer to close out its open fail to deliver position prior to the applicable close-out date is more effective at achieving that goal than requiring a broker-dealer to close out its open short position prior to the applicable close-date because a broker-dealer's open short position could far exceed its open fail to deliver position and, therefore, requiring close out of the potentially smaller fail to deliver position only is more likely to encourage broker-dealers to close out such positions early. Thus, in contrast to temporary Rule 204T(e)(3), Rule 204(e)(3) provides that a broker-dealer must purchase or borrow a quantity of securities sufficient to cover the entire amount of that broker-dealer's fail to deliver position at a registered clearing agency in that security, rather than the entire amount of the broker-dealer's open short position.[121]

In addition, to help ensure that broker-dealers purchase sufficient shares to close out their fail to deliver positions, Rule 204(e)(4) incorporates the condition of temporary Rule 204T(e)(4) that the broker-dealer that is purchasing or borrowing securities must be net flat or net long in that security on its books and records on the day of the purchase or borrow.[122] Consistent with temporary Rule 204T(e)(4), Rule 204(e)(4) requires that the broker-dealer demonstrate that it has complied with this requirement.[123] This requirement will enable the Commission and SROs to monitor more effectively whether or not a broker-dealer has complied with the requirements of Rule 204(e).

D. Market Makers

To allow broker-dealers that are market makers to facilitate customer orders in a fast moving market, temporary Rule 204T includes a limited exception from the temporary rule's close-out requirement for fails to deliver attributable to bona fide market making activities by registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market. Temporary Rule 204T requires that such fails to deliver are closed out by no later than the beginning of regular trading hours on the third settlement day following the settlement date for the transaction (*i.e.,* T+6).[124]

Similar to commenters' discussions regarding extending the close-out period to the end of the day for fails to deliver subject to the requirements of temporary Rule 204T(a) and (a)(1), commenters requested that we extend the market maker close-out period under temporary Rule 204T(a)(3) to the end of regular trading hours on the close-out date to help reduce buy-in risk.[125]

We recognize commenters' concerns regarding the market impact of temporary Rule 204T's close-out requirements, particularly at the market open. As discussed above, however, we believe, at this time, that it is appropriate to adopt temporary Rule 204T's requirement that fails to deliver, including fails to deliver resulting from market making activity, are closed out by no later than the beginning of regular trading hours on the applicable close-out date to help further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and to maintain the benefits achieved pursuant to temporary Rule 204T. Thus, Rule 204(a)(3) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security that is attributable to bona fide market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, immediately close out the fail to deliver position.[126]

In contrast to temporary Rule 204T(a)(3), however, Rule 204(a)(3) permits a participant to borrow securities to close-out a fail to deliver position. In temporary Rule 204T, we required a participant to purchase securities to close out fails to deliver attributable to bona fide market making activity to be consistent with the close-out requirements of Rule 203(b)(3) of Regulation SHO which require that a participant that has a fail to deliver position in a threshold security for thirteen consecutive settlement days immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity.[127]

Rule 204(a)(3) permits a borrow as well as a purchase to close out a fail to deliver position because we believe that such an amendment is consistent with our goal of maintaining the recent reduction in fails to deliver because it will provide additional flexibility to participants in closing out fail to deliver positions.[128] Permitting a borrow as well as a purchase will also make the close-out requirements of Rule 204(a)(3) consistent with the close-out requirements of Rule 204(a) and (a)(1).

As noted above and consistent with temporary Rule 204T, the close-out requirements of Rule 204 require that a broker-dealer take affirmative action to close out the fail to deliver position by purchasing or borrowing securities. Thus, under Rule 204(a)(3), a market maker may not offset the amount of a fail to deliver position with shares that

[118] *See infra* Section III.F. (discussing bona fide purchases and borrows for purposes of the close-out requirements of Rule 204); *see also* 17 CFR 203(b)(3)(vii).

[119] *See* letter from SIFMA.

[120] *See id.*

[121] *See* Rule 204(e)(3).

[122] *See* Rule 204(e)(4).

[123] *See id.*

[124] *See* temporary Rule 204T(a)(3).

[125] *See, e.g.,* letters from NYSE; CBOE; The Specialist Association (discussing increased volatility at the opening of trading due to the requirement under temporary Rule 204T that fails to deliver be closed out by no later than the beginning of regular trading hours). One commenter recommended that we also extend the close-out period to five settlement days after settlement date (*i.e.,* T+8) for fails to deliver resulting from bona fide market making activity. *See* letter from CBOE. For the reasons set forth in section III.A.1 above, discussing generally the close-out periods under Rule 204, we have determined not to extend the close-out period to provide additional days to close out such fails to deliver.

[126] *See* Rule 204(a)(3).

[127] *See* 17 CFR 242.203(b)(3).

[128] *See* letter from CBOE (stating that the close-out procedures under temporary Rule 204T for fails to deliver attributable to bona fide market making activity should be amended to permit borrows or purchases throughout the close-out period).

it receives or will receive during the close-out date.[129]

Temporary Rule 204T(b)(2) included an exception from the borrowing requirements of temporary Rule 204T(b) for market makers that can demonstrate that they do not have an open short position in the equity security at the time of any additional short sales.[130] We do not believe that a similar exception is necessary under Rule 204(b) because, as with other broker-dealers, a market maker is excepted from the borrowing requirements of Rule 204(b) if it timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that it is in compliance with the requirements of Rule 204(e). Because Rule 204(b) includes an exception applicable to all broker-dealers, including market makers, we do not think it is necessary to maintain a separate exception applicable only to market makers.

E. Sales of Certain Deemed To Own Securities

Temporary Rule 204T(a)(2) includes an exception from the temporary rule's close-out requirements for sales of Rule 144 Securities.[131] Specifically, temporary Rule 204T(a)(2) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in an equity security sold pursuant to Rule 144 for thirty-five consecutive settlement days after the settlement date for a sale in that equity security, the participant shall, by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.[132]

Regulation SHO provides an exception from the ''locate'' requirement of Rule 203(b)(1) for situations where a broker-dealer effects a short sale on behalf of a customer that is deemed to own the security pursuant to Rule 200 of Regulation SHO, although, through no fault of the customer or broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date and, therefore, is a ''short'' sale under the marking requirements of Rule 200(g). Rule 203(b)(2)(ii) of Regulation SHO provides that in such circumstances, delivery must be made on the sale as soon as all restrictions on delivery have been removed, and in any event no later than 35 days after trade date, at which time the broker-dealer that sold on behalf of the person must either borrow securities or close out the open position by purchasing securities of like kind and quantity.[133] In addition, in 2007 we adopted amendments to the close-out requirement of Regulation SHO to allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 to be closed out within 35 rather than 13 consecutive settlement days.[134]

We included in temporary Rule 204T an exception for Rule 144 Securities because these securities are formerly restricted securities that a seller is ''deemed to own,'' as defined by Rule 200(a) of Regulation SHO.[135] The securities, however, may not be capable of being delivered on the settlement date due to processing delays related to removal of the restricted legend and, therefore, sales of these securities frequently result in fails to deliver. In addition, this exception is consistent with our statements in connection with our recent amendments to Rule 203(b)(3) of Regulation SHO which extended the close-out requirements of that rule for fails to deliver in threshold securities sold pursuant to Rule 144.[136] We limited the exception in temporary Rule 204T to Rule 144 Securities, rather than extending the exception to all formerly restricted securities that a seller is ''deemed to own,'' to remain consistent with Rule 203(b)(3) of Regulation SHO.

In response to a request for comment, one commenter that discussed the requirements of temporary Rule 204T(a)(2) relating to fails to deliver resulting from sales of Rule 144 Securities urged the Commission to retain the exception, and to extend it to cover sales of other securities that a person owns, but is unable to deliver on settlement date.[137] In particular, the commenter stated that the exception should apply to the same universe of securities to which the exception in Rule 203(b)(2)(ii) of Regulation SHO applies.[138] In addition, the commenter stated that for those securities subject to the close-out requirements of temporary Rule 204T(a)(2) and the delivery requirements of Rule 203(b)(2)(ii) there is confusion as to which time-frame for closing out fails to deliver resulting from sales of these securities should apply.[139] We note, however, that rather than changing the close-out requirement of temporary Rule 204T(a)(2), this commenter recommended extending the delivery time-frame of Rule 203(b)(2)(ii) of Regulation SHO to 35 settlement days, rather than calendar days, from trade date.[140]

After considering the comments and to provide consistency between the delivery requirements of Rule 203(b)(2)(ii) of Regulation SHO and the close-out requirements of Rule 204, we are adopting in Rule 204(a)(2) the requirements of temporary Rule 204T(a)(2) with some modifications. Specifically, we are expanding the universe of securities to which Rule 204(a)(2) will apply. It will apply to fails to deliver resulting from the sale of an equity security that a person is ''deemed to own'' pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed.[141] In addition, we are revising the close-out period within which a participant must close out fails to deliver resulting from sales of such securities to be consistent with the delivery period contained in Rule

[129] *See supra* note 81 and supporting text.

[130] *See* temporary Rule 204T(b)(2).

[131] *See* 17 CFR 230.144.

[132] *See* temporary Rule 204T(a)(2).

[133] *See* 17 CFR 242.203(b)(2)(ii). In the 2004 Regulation SHO Adopting Release, the Commission stated that it believed that 35 calendar days is a reasonable outer limit to allow for restrictions on a security to be removed if ownership is certain. In addition, the Commission noted that Section 220.8(b)(2) of Regulation T of the Federal Reserve Board allows 35 calendar days to pay for securities delivered against payment if the delivery delay is due to the mechanics of the transactions. *See* 2004 Regulation SHO Adopting Release, 69 FR 48015, n.72.

[134] *See* 2007 Regulation SHO Final Amendments, 72 FR 45550–45551.

[135] *See* 17 CFR 242.200(a).

[136] *See* 2007 Regulation SHO Final Amendments, 72 FR 45550–45551.

[137] *See* letter from SIFMA.

[138] *See id.*; *see also supra* note 133, and accompanying text.

[139] *See* letter from SIFMA.

[140] *See id.*

[141] Such circumstances could include the situation where a convertible security, option, or warrant has been tendered for conversion or exchange, but the underlying security is not reasonably expected to be received by settlement date. *See* 2004 Regulation SHO Adopting Release, 69 FR 48015; *see also* 17 CFR 242.200(b) (defining when a person shall be ''deemed to own'' a security). Another situation could include the sale of a Rule 144 Security. *See* Rule 204T Adopting Release, 73 FR 61715. In addition, we understand that sellers that own restricted equity securities that wish to sell pursuant to an effective resale registration statement under Rule 415 under the Securities Act experience similar types of potential settlement delays as sales of Rule 144 Securities. Thus, fails to deliver in such securities may be closed out in accordance with Rule 204(a)(2) if the fails to deliver resulted from sales of securities that were outstanding at the time they were sold and the sale occurred after a registration has become effective. In addition, we understand that sales pursuant to broker-assisted cashless exercises of compensatory options to purchase a company's stock, may result in potential settlement delays and, therefore, fails to deliver. Such fails to deliver may be closed out in accordance with Rule 204(a)(2).

203(b)(2)(ii) of Regulation SHO. Accordingly, Rule 204(a)(2) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security resulting from the sale of a security that a person is deemed to own pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed, the participant shall, by no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.[142]

In addition to being consistent with the delivery time-frame under Rule 203(b)(2)(ii) of Regulation SHO, we believe that a close-out requirement of 35 consecutive calendar days from trade date for fails to deliver resulting from sales of such owned securities will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). Because the security being sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such fail to deliver position by purchasing securities in the market. In addition, we note that although a commenter requested that we maintain the close-out requirement of temporary Rule 204T(a)(2) but amend the delivery time-frame of Rule 203(b)(2)(ii) of Regulation SHO to 35 settlement rather than calendar days, we have determined not to make such an amendment because we believe that 35 calendar days from trade date should be a sufficient period of time within which delivery can be made on sales of such securities. We also note that 35 calendar days from trade date is the delivery time-frame with which broker-dealers have had to comply since the effective date of Regulation SHO in January 2005, if relying on the exception in Rule 203(b)(2)(ii) to the rule's locate requirement. We are not aware that broker-dealers have been unable to comply with this delivery requirement.

Although this amendment will provide an extended period of time within which fails to deliver resulting from sales of certain ''deemed to own'' securities must be closed out, we believe that such additional time is warranted and does not undermine our goal of reducing fails to deliver because these are sales of owned securities that cannot be delivered by settlement date due solely to processing delays outside the seller's or broker-dealer's control. Moreover, delivery will be made on such sales as soon as all restrictions on delivery have been removed. In addition, Rule 204(b)'s borrowing requirements will help ensure that, if a fail to deliver position is not closed out in accordance with Rule 204(a)(2), additional fails to deliver cannot occur until securities have been purchased to close out the fail to deliver position and such purchase has cleared and settled. If a participant does not close out a fail to deliver position at a registered clearing agency in accordance with Rule 204(a)(2), the rule prohibits the participant, and any broker-dealer from which it receives trades for clearance and settlement, including market makers, from accepting any short sale orders or effecting further short sales in the particular security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.[143] In addition, we intend to closely monitor whether fails to deliver are being closed out in accordance with the requirements of Rule 204(a)(2).

F. Sham Close-Outs

In the Rule 204T Adopting Release, we stated that it is possible under Regulation SHO that a close out by a participant of a registered clearing agency may result in a fail to deliver position at another participant if the counterparty from which the participant purchases securities fails to deliver. We also noted, however, that Regulation SHO prohibits a participant of a registered clearing agency, or a broker-dealer for which it clears transactions, from engaging in ''sham close outs'' by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a fail to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another fail to deliver position.[144] Because these same concepts apply to the close-out requirements of Rule 204, we have determined to include rule text in subparagraph (f) of Rule 204 to provide that a participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of Rule 204 where the participant enters into an arrangement with another person to purchase or borrow securities as required by Rule 204, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow.[145]

G. De Minimis Fail To Deliver Positions

Some commenters requested that the Commission consider including an exception from temporary Rule 204T's close-out requirements where a participant's fail to deliver position at a registered clearing agency is below a certain amount.[146] One commenter suggested that such an exception be voluntary so that firms could decide whether or not to take advantage of the exception based on their particular business model and capabilities.[147] Another commenter noted that *de minimis* fails to deliver are particularly likely to occur in connection with odd lot trading.[148] This commenter stated that it believes that permitting a *de minimis* fail to deliver, particularly in less-than-round lots, would not undermine the intent of temporary Rule 204T.[149] Other commenters, in discussing odd lot orders and fails to deliver, recommended a *de minimis* exception for fails to deliver of less than 1,000 shares.[150] One other commenter recommended a *de minimis* exception that would except a fail to deliver position from the close-out requirements if the net value of the fail in the particular security across all firm accounts is under one million dollars.[151]

A primary goal of Rule 204 is to continue the recent reduction in fails to deliver. We believe that an exception

[142] *See* Rule 204(a)(2).

[143] *See* Rule 204(b).

[144] *See* Rule 204T Adopting Release, 73 FR 61714, n.78; *see also* 17 CFR 242.203(b)(3)(vii); 2004 Regulation SHO Adopting Release, 69 FR 48018, n.96.

[145] *See* Rule 204(f).

[146] *See, e.g.,* letters from SIFMA; NYSE; Wedbush; Lek Securities Corporation; CBOE; BATS; EWT; The Specialist Association.

[147] *See* letter from SIFMA.

[148] *See, e.g.,* letter from NYSE (stating that by operation of NYSE and NYSE Alternext rules, odd lot executions take place automatically, with the designated market maker (''DMM'') acting as the contra-side to all odd lot trades. As a result, DMMs may sell short in a *de minimis* amount automatically and without prior knowledge. This commenter further stated that if the odd lot trade occurs in hard-to-borrow or illiquid securities, the DMM may not be able to avoid failing to deliver).

[149] *See* letter from NYSE.

[150] *See* letters from The Specialist Association; Wedbush.

[151] *See* letter from EWT; *see also* letter from Lek Securities Corporation.

from Rule 204's close-out requirements that would permit certain fails to deliver to persist indefinitely could undermine this goal. Accordingly, we have determined at this time not to include a *de minimis* or odd-lot related exception that would permit such fails to deliver to not have to be closed out. We will continue to monitor, however, whether a *de minimis* or odd-lot related exception is appropriate.

IV. Administrative Procedure Act

Section 553(d) of the Administrative Procedure Act (''APA'') provides that a substantive rule generally may not be made effective less than 30 days after notice is published in the **Federal Register.**[152] Section 553(d), however, also provides an exception to the 30-day requirement where an agency finds good cause for providing a shorter effective date.[153]

Temporary Rule 204T will expire on July 31, 2009. Rule 204 makes permanent the provisions of temporary Rule 204T with limited modifications to address commenters' concerns and to help ensure the workability of the rule on a permanent basis. Rule 204 is intended to help maintain the benefits achieved in part by temporary Rule 204T, such as maintaining the recent reduction in fails to deliver, and address potentially abusive ''naked'' short selling by strengthening the close-out requirements of Regulation SHO. A gap between the expiration of temporary Rule 204T and the effective date of Rule 204 would be contrary to these purposes and goals. Rule 204 in significant part, moreover, continues the restrictions on short selling that are currently in place, and with which participants are already familiar. In addition, the modifications that are made in Rule 204 from Rule 204T relieve participants of some of the regulatory burdens imposed by temporary Rule 204T by, for example, allowing participants to close out fail to deliver positions from long sales and market making activities by borrowing securities. Thus, the Commission finds that there is good cause for making Rule 204 effective on July 31, 2009.

V. Amendments to Rule 30–3

The Commission is adopting an amendment to Rule 30–3 of its Rules of Organization and Program Management governing delegations of authority to the Director of the Division of Trading and Markets (the ''Director'').[154] The amendment delegates to the Director the authority to grant by order an exemption from the provisions of Regulation SHO of the Exchange Act, under Section 36 of the Exchange Act. Such an exemption may be granted either unconditionally, or on specified conditions.

Section 36 of the Exchange Act provides that ''the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this chapter or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.'' [155]

This delegation of authority to the Director is intended to conserve Commission resources and provide market participants needed flexibility by allowing the staff, pursuant to Section 36(a) of the Exchange Act, to review and act by order on applications for exemptions from Regulation SHO. Pursuant to the amendment, the Director may consider and act upon appropriate requests for relief from the provisions of Regulation SHO, and will consider the particular facts and circumstances relevant to each such request, the potential ramifications of granting any exemptive relief, and any appropriate conditions to be imposed as part of such an exemption.

The Commission anticipates that the delegation of authority will facilitate efficient review. Nevertheless, the staff may submit matters to the Commission for consideration as it deems appropriate, and the Commission ''may, in its sole discretion, decline to entertain any application for an order of exemption under this section.'' [156]

The Commission finds, in accordance with the Administrative Procedure Act, 5 U.S.C. 553(b)(3)(A), that this amendment to Rule 30–3 relates solely to agency organization, procedure and practice and thus, notice and the opportunity for public comment before its effective date are unnecessary. In addition, because the amendment to Rule 30–3 relates solely to the internal processes of the Commission with regard to the grant of exemptions from the provisions of Regulation SHO, the Commission finds, pursuant to Section 553(d)(3) of the Administrative Procedure Act, 5 U.S.C. 553(d)(3), that there is good cause for making the amendment effective upon publication in the **Federal Register**. For similar reasons, the amendment does not require an analysis under the Regulatory Flexibility Act or analysis of major status under the Small Business Regulatory Enforcement Fairness Act.[157]

VI. Paperwork Reduction Act

Like temporary Rule 204T, several provisions under Rule 204 will impose a ''collection of information'' within the meaning of the Paperwork Reduction Act of 1995 (''Paperwork Reduction Act'').[158] These collections of information are mandatory. With the single exception of the elimination in Rule 204 of the exception in temporary Rule 204T(b)(2) for market makers from the borrowing requirement in Rule 204(b),[159] all collections of information from temporary Rule 204T have been incorporated into Rule 204 without modification. The collection of information requirements of temporary Rule 204T have not been substantively or materially modified in Rule 204; therefore, the time and cost estimates for compliance with these provisions are the same for Rule 204 as our prior time and cost estimates for temporary Rule 204T, which we incorporate by reference.[160]

We published a notice of our estimated time requirements for participants to comply with these collection of information provisions and requested comment on the collection of information requirements in connection with temporary Rule 204T. We submitted the collection of information to OMB for review and approval in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13.

One commenter indicated that compliance with temporary Rule 204T resulted in an increase in man-hours to monitor multiple levels of data across various system platforms and business

[152] 5 U.S.C. 553(d).

[153] *See id.* at 553(d)(1), (d)(3).

[154] *See* 17 CFR 200.30–3.

[155] *See* 15 U.S.C. 78mm(a).

[156] *See* 15 U.S.C. 78mm(a)(2).

[157] *See* 5 U.S.C. 601(2) (for purposes of Regulatory Flexibility Act analysis, the term ''rule'' means any rule for which the agency publishes a general notice of proposed rulemaking) and 5 U.S.C. 804(3)(C) (for purposes of congressional review of agency rulemaking, the term ''rule'' does not include any rule of agency organization, procedure, or practice that does not substantially affect the rights or obligations of non-agency parties).

[158] 44 U.S.C. 3501 *et seq.*

[159] In contrast to temporary Rule 204T(b), Rule 204(b) does not include an exception from the borrowing requirement of the Rule specific to market makers. We eliminated this exception because, as with other broker-dealers, a market maker is excepted from the borrowing requirements of Rule 204(b) if it timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at the registered clearing agency or that it is in compliance with the requirements of Rule 204(e). Market makers, like all other broker-dealers, will continue to be subject to the certification requirements under Rule 204(b). *See supra* Section III.B. (discussing Rule 204(b)).

[160] *See* Rule 204T Adopting Release, 73 FR 61717–61722.

units within a firm,[161] and other commenters expressed general concerns with the administrative and operational burdens on clearing firms, customers, and their regulators.[162] The Commission, however, did not receive any comments as to the burdens associated with the collection of information requirements in temporary Rule 204T.

The information collected under Rule 204 will continue to be retained and/or provided to other entities pursuant to the specific rule provisions and will be available to the Commission and SRO examiners upon request. The information collected will continue to aid the Commission and SROs in monitoring compliance with these requirements. In addition, the information collected will aid those subject to Rule 204 in complying with its requirements.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for the collection of information is changed from ''Temporary Rule 204T'' to ''Rule 204'' to indicate that the collection is no longer with regard to a temporary rule and the OMB control number for the collection of information is 3235–0647.

VII. Cost-Benefit Analysis

A. Summary

The Commission is sensitive to the costs and benefits of its rules and we have considered such with respect to the adoption of Rule 204 of Regulation SHO. We are incorporating by reference the cost-benefit discussion in the Rule 204T Adopting Release, except to the extent that we have made modifications or because we are addressing comments.

In order to assist our evaluation, we solicited comment via questions as to the costs and benefits of temporary Rule 204T, which is substantially similar to Rule 204. We address these comments as applied to permanent Rule 204 in detail below. In addition, we discuss in more detail below that we believe the benefits of adopting Rule 204 justify its costs. We also believe that the benefits of adopting Rule 204 justify forgoing benefits that might accrue if the Commission were to allow temporary Rule 204T to expire without a substantially similar replacement.[163]

As discussed above, preliminary results from OEA indicate that our actions to further reduce fails to deliver and, thereby, help address potentially abusive ''naked'' short selling are having their intended effect. For example, these preliminary results indicate a significant downward trend in the number of fails to deliver in all equity securities since, in addition to other measures, the adoption of temporary Rule 204T.[164]

Due to the positive impact that temporary Rule 204T, among other actions, is having on reducing fails to deliver and after considering the comments received, we believe adopting the provisions of that rule in a permanent rule, Rule 204 of Regulation SHO, with limited modifications to promote the rule's workability and address commenters' concerns, will further the goals outlined above and below. We believe these modifications will aid compliance with Rule 204.

We believe that Rule 204 will help maintain the recent reduction in fails to deliver and address potentially abusive ''naked'' short selling in all equity securities by requiring that, subject to certain limited exceptions, if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency it must immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurs the fail to deliver position. We recognize that, like temporary Rule 204T, Rule 204 may impose increased purchasing and borrowing costs beyond those that would occur if the rule was not in place and that these costs may increase the costs of legitimate short selling. We believe, however, that continuing the requirements of temporary Rule 204T by adopting them in Rule 204 is necessary to maintain the reduction in fails to deliver and to continue to address potentially abusive ''naked'' short selling. We believe that continuing these benefits achieved under temporary Rule 204T justifies the potential costs associated with making the requirements of that rule permanent.

Further, we believe that the benefits of making the requirements of temporary Rule 204T permanent in Rule 204 will justify forgoing any potential benefits that might accrue if the Commission were to allow temporary Rule 204T to expire. If the Commission were to allow temporary Rule 204T to expire without replacement, there might be potential benefits. For example, some commenters noted that they believe that there has been price disruption and market volatility resulting from temporary Rule 204T's requirement that participants close out fails to deliver by no later than the beginning of regular trading hours on the applicable close-out date.[165] Some commenters stated that temporary Rule 204T's close-out requirements cause over-buying and over-borrowing at the market open by parties seeking to meet the close-out requirements and has unnecessarily interfered in transactions that would settle in the normal course.[166]

If we were to allow temporary Rule 204T to expire without adopting a substantially similar rule, the marketplace would revert back to the close-out requirements of Rule 203(b)(3) of Regulation SHO that apply only to those securities with a large and persistent level of fails to deliver, *i.e.,* threshold securities, and only to those fail to deliver positions that have persisted for thirteen consecutive settlement days.[167] Thus, it is plausible that a return to this pre-temporary Rule 204T close-out requirement might alleviate concerns expressed by commenters regarding potential over-buying, over-borrowing, volatility, and price disruption at the market open, be easier to comply with and, therefore, potentially reduce transaction costs to market participants. Further, according to some commenters, temporary Rule 204T may provide disincentives to lenders of securities and, thus, may cause lower liquidity levels in the market place.[168]

In addition, if we were to allow temporary Rule 204T to expire without taking substantially similar action, participants might experience fewer costs in terms of monitoring systems platforms and notification obligations associated with complying with temporary Rule 204T[169] and with Rule

[161] *See* letter from SIFMA. The commenter noted that one firm indicated its operations personnel initially spent an extra 60 man-hours per day to comply with the rule, but acknowledged that time amount had tapered down through automation. The comment is addressed more directly in the cost-benefit analysis in Section VII below.

[162] *See e.g.,* letters from CBOE; State Street.

[163] Temporary Rule 204T will expire on July 31, 2009.

[164] *See* Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, November 26, 2008 at *http://www.sec.gov/comments/s7-30-08/s73008-37.pdf; see also* Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, March 20, 2009 at *http://www.sec.gov/comments/s7-30-08/s73008-107.pdf;* Memorandum from OEA Re: Impact of Recent SHO Rule Changes on Fails to Deliver, April 16, 2009 at *http://www.sec.gov/comments/s7-30-08/s73008-121.pdf.*

[165] *See e.g.,* letters from BATS; LEK; MFA; SIFMA; State Street.

[166] *See, e.g.,* letter from SIFMA.

[167] *See* 17 CFR 242.203(b)(3).

[168] *See* letters from BATS; ICI; SIFMA.

[169] *See* letters from CBOE; SIFMA; State Street (noting some of the potential costs associated with

204. For instance, the demonstration and notification requirements of temporary Rule 204T and Rule 204 and related compliance costs in terms of personnel, recordkeeping, systems, and surveillance mechanisms would not apply. However, as noted in the temporary Rule 204T Adopting Release, we believe any potential additional costs incurred in implementing the collection of information requirements under temporary Rule 204T would be minimal. We believe the same with respect to the costs associated with Rule 204. In addition, we note that most of the infrastructure necessary to comply with Rule 204 should already be in place in order to meet the close-out requirements of Rule 203(b)(3) of Regulation SHO and, more recently, of temporary Rule 204T.

For the reasons articulated above and below, in more detail, we believe that a reversion to the pre-temporary Rule 204T close-out regime would result in a number of costs to the securities markets in the forms of an increase in the level of fails to deliver and a lack of incentive for sellers to promptly deliver securities by settlement date. Such results would undermine our goals of reducing fails to deliver and addressing potentially abusive ''naked'' short selling.

As previously noted, and stated in the temporary Rule 204T Adopting Release, we are concerned that the close-out requirements of Regulation SHO do not adequately address our goals of reducing fails to deliver and addressing potentially abusive ''naked'' short selling.[170] In part due to such concerns, we have taken measures to help further reduce fails to deliver in all equity securities. As discussed above, OEA's findings regarding the impact of temporary Rule 204T, and other Commission actions, indicate a significant reduction in the number of fails to deliver.[171] Thus, we believe it is necessary to adopt temporary Rule 204T's close-out requirements in a permanent rule, Rule 204, such that fails in all equity securities must be closed out within specific timeframes and, thereby, help maintain the recent reduction in fails to deliver and the benefits already achieved.

B. Benefits

By continuing to require that participants of a registered clearing agency immediately close-out a fail to deliver position on the applicable close-out date, Rule 204 will further our goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling. This, in turn, will help to ensure that investors remain confident that trading can be conducted without the influence of illegal manipulation.[172] The rule also furthers the goals of helping to maintain fair and orderly markets against the threat of sudden and excessive fluctuations of securities prices and substantial disruption in the functioning of the securities markets. The rule also promotes the prompt and accurate clearance and settlement of transactions in equity securities.

In addition, by helping to further our goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, Rule 204, like temporary Rule 204T, will help continue to address concerns that fails may create a misleading impression of the market for securities. Large and persistent fails to deliver may have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending.[173] Thus, by facilitating the prompt receipt of shares, Rule 204 will help enable investors to receive the benefits associated with share ownership.

Persistent fails to deliver in a security may also be perceived by potential investors negatively and may affect their investment decisions.[174] Thus, providing greater assurance that securities will be delivered might help alleviate investor apprehension about investing in certain securities and increase investor confidence in the settlement process.[175]

1. Close-Out Requirements

By maintaining the close-out requirements of temporary Rule 204T we believe Rule 204 will continue to help restore, maintain, and enhance investor confidence in the securities markets. It will also help continue to limit the use of manipulative schemes involving ''naked'' short selling in all equity securities.[176] Without the requirements of Rule 204, sellers that fail to deliver securities on settlement date may attempt to engage in trading activities that deliberately depress the price of a security. Rule 204's close-out requirements will continue the limitations on a potential means of manipulation, thereby decreasing the possibility of artificial market influences and contributing to price efficiency. Rule 204's close-out requirements are also expected to prevent large, widespread build-ups of fails over time.

As in temporary Rule 204T(a), Rule 204(a) provides that a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date or, if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.[177] Similarly, consistent with temporary Rule 204T(a)(1) and (a)(3), the close-out requirements of Rule 204(a)(1) and (a)(3) for fails to deliver resulting from long sales and certain bona fide market making activity must be closed out by the beginning of regular trading hours on the close-out date for such fails to deliver (*i.e.,* T+6).[178]

As discussed in Section III above, some commenters requested that we extend the close-out period for fails to deliver resulting from short sales, long sales, and bona fide market making activity from the beginning to the end of regular trading hours on the applicable close-out date. Commenters expressed concern that temporary Rule 204T's requirement to close out fails to deliver by no later than the beginning of regular trading hours can create buying pressure at the open, that may temporarily distort the price of the security.[179]

Other commenters requested additional days within which to close

complying with temporary Rule 204T's close-out requirements).

[170] *See, e.g.,* Rule 204T Adopting Release, 73 FR 61711–61712.

[171] *See supra* note 164.

[172] *See* 2006 Regulation SHO Proposed Amendments, 71 FR 41712; 2007 Regulation SHO Final Amendments, 72 FR 45545; 2007 Regulation SHO Proposed Amendments, 72 FR 45558–45559; Anti-Fraud Rule Proposing Release, 73 FR 15378; Rule 204T Adopting Release, 73 FR 61709–61710 (providing discussion of the impact of fails to deliver on the market); *see also* 2003 Regulation SHO Proposing Release, 68 FR 62975 (Nov. 6, 2003) (discussing the impact of ''naked'' short selling on the market).

[173] *See supra* Section II. (discussing the potential negative impact of large and persistent fail to delivers).

[174] *See id.*

[175] *See id.*

[176] *See* 204T Adopting Release, 73 FR 61709–61710.

[177] *See* Rule 204(a).

[178] *See* Rules 204(a)(1) and 204(a)(3).

[179] *See, e.g.,* letters from MFA; CBOE; SIFMA; BATS; RMA; State Street.

out fails to deliver in connection with short sales. For example, some commenters requested that the Commission extend the close-out period for fails to deliver resulting from short sales to three settlement days after the fail occurs, consistent with the close-out period for fails to deliver resulting from long sales and market making activity.[180] Other commenters requested that the Commission extend the close-out requirement for fails to deliver resulting from all sales to five settlement days after the fail to deliver position occurs.[181] These commenters stated that the additional time to close out fails to deliver would allow the majority of trades to clear and settle on their own within a few days following the regular settlement date (*i.e.,* T+3).[182]

Some commenters expressed concerns about the effect of the close-out requirements of temporary Rule 204T on securities lending.[183] One commenter also noted that in practice fails to deliver resulting from sales of securities on loan, which are considered ''long'' sales, are often closed out in accordance with the time-frames for fails to deliver resulting from short sales rather than long sales because temporary Rule 204T does not provide sufficient time to determine whether or not a fail to deliver position resulted from a long or short sale.[184] According to this commenter, because some broker-dealers are purchasing securities by no later than the beginning of regular trading hours on the settlement date after the fail to deliver occurs, in accordance with the close-out requirements for short sales, such purchasing activity acts as a disincentive to lending and causes institutions to question their participation in lending programs.[185]

Other commenters stated that where the holder of a long position sells securities that have been financed through a securities loan, the close-out requirements of temporary Rule 204T may not provide sufficient time for the securities to be recalled and delivered in time for settlement of the sale transaction.[186] These commenters stated, among other things, that temporary Rule 204T's requirement that securities be delivered by no later than the beginning of regular trading hours does not allow for the completion of the securities lending cycle, which may not occur until the close of the DTC settlement window on the third settlement day after settlement date (*i.e.,* T+6).[187]

Although we recognize commenters' concerns regarding the potential market impact of the close-out requirements of temporary Rule 204T, particularly at the market open, we believe that these potential concerns are justified by the benefits of retaining in Rule 204 the strict close-out requirements of temporary Rule 204T. As discussed above, since the adoption of temporary Rule 204T, and other actions taken by the Commission aimed at reducing fails to deliver, there has been a significant reduction in fails to deliver. To maintain this reduction, we believe it is appropriate at this time to continue to require that participants close out fails to deliver by no later than the beginning of regular trading hours on the applicable close-out date. Thus, we are adopting as a permanent rule the requirement that fails to deliver resulting from short sales, long sales, and certain bona fide market making activity must be closed out by no later than the beginning of regular trading hours on the applicable close-out date.

In addition, we believe that continuing to require that fails to deliver be closed out on the day immediately following the day on which the fail to deliver occurs is consistent with our goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing ''naked'' short selling and, in particular, potentially abusive ''naked'' short selling. Although extending the time-frames within which fails to deliver must be closed out may allow for ordinary course settlement, as several commenters contend, we believe that the close-out requirements of Rule 204 are necessary to help encourage delivery by settlement date and achieve our goal of not allowing fails to deliver to persist.[188]

As we discussed in the Rule 204T Adopting Release, we believe that delivery on sales should be made by settlement date.[189] In the Rule 204T Adopting Release, we noted that the vast majority of fails to deliver are closed out within five days after T+3.[190] In addition, in that release we referenced a recent analysis by OEA that found that more than half of all fails to deliver and more than 70% of all fail to deliver positions are closed out within two settlement days after T+3.[191] We also noted in that release, however, that although this information shows that delivery is being made, it demonstrates that often delivery is not being made until several days following the standard three-day settlement cycle.

In addition, as discussed above, fails to deliver may be associated with a scheme to manipulate the price of a security. We are also concerned about the negative effect that fails to deliver and potentially abusive ''naked'' short selling may have on individual securities and the broader market, including on investor confidence.[192] The close-out requirements of Rule 204 help address these concerns by encouraging timely settlement and not allowing fails to deliver to persist.

We understand, however, that fails to deliver may occur from long sales within the first two settlement days after settlement date for legitimate reasons. For example, human or mechanical errors or processing delays can result from transferring securities in custodial or other form rather than book-entry form, thereby causing a fail to deliver on a long sale.

Thus, in Rule 204(a)(1), we are adopting, with certain limited modifications, the provisions of temporary Rule 204T(a)(1) relating to closing out fails to deliver resulting from long sales. Specifically, Rule 204(a)(1) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security and the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day

[180] *See, e.g.,* letters from EWT; Coalition of Private Investment Companies; SIFMA; MFA; State Street.

[181] *See, e.g.,* letters from CBOE; Options Exchanges.

[182] *See, e.g.,* letters from SIFMA; MFA; State Street; CBOE; Options Exchanges; Coalition of Private Investment Companies.

[183] *See, e.g.,* letter from SIFMA.

[184] *See* letter from SIFMA; *see also* letters from RMA; ICI.

[185] *See* letter from SIFMA; *see also* letter from RMA (recommending the extension of the close-out period for fails to deliver for all sales to settlement date plus three days (*i.e.,* T+6) ''to ensure that beneficial owners selling on-loan positions are not compromised by close-outs of long sales on T+4'').

[186] *See* letters from EWT; BATS; RMA; ICI; Wedbush.

[187] *See* letters from EWT; BATS; RMA; ICI; RMA.

[188] *See supra* note 16 (discussing the standard three-day settlement cycle).

[189] *See* Rule 204T Adopting Release, 73 FR 61712–61713.

[190] *See id.*

[191] *See id.* at n. 68. We note that OEA's analysis examined the period from January to July 2008 and used the age of the fail to deliver position as reported by the NSCC. The NSCC data included only securities with at least 10,000 shares in fails to deliver. These numbers also included securities that were not subject to the close-out requirement in Rule 203(b)(3) of Regulation SHO, which applies only to ''threshold securities'' as defined in Rule 203(c)(6) of Regulation SHO.

[192] *See, e.g.,* Anti-Fraud Rule Adopting Release, 73 FR 61666.

following the settlement date immediately close out the fail to deliver position by purchasing or borrowing securities of like kind and quantity.[193]

In addition, consistent with temporary Rule 204T(a)(3), Rule 204(a)(3) extends the close-out requirement for fails to deliver attributable to certain bona fide market making activities by requiring a participant to close out the fail to deliver position attributable to such activities by no later than the beginning of regular trading hours on the third settlement day after the settlement date. We believe this exception to Rule 204(a)'s close-out requirement benefits clearing agency participants because the two additional days to close-out these fail to deliver positions may reduce close-out costs for such participants.

Although we have determined at this time not to provide additional time within which fails to deliver must be closed out on the applicable close-out date, we are providing additional flexibility to the close-out requirements for fails to deliver resulting from long sales and certain bona fide market making activity by, in contrast to temporary Rule 204T(a)(1) and (a)(3), providing in Rule 204(a)(1) and (a)(3) the ability to borrow as well as purchase securities to close out a fail to deliver position. As some commenters noted, we believe that the ability to borrow a security to close-out a fail to deliver position may have less market impact than a purchase, while serving the objective of closing-out a fail position.[194] In addition, we believe that the additional flexibility afforded by the ability to close out a fail to deliver position either through a purchase or a borrow, will allow participants to access additional liquidity sources, thereby potentially reducing close-out costs and helping to ensure that fails to deliver are closed out on the applicable close-out date.[195]

Temporary Rule 204T(d) provides that a participant may reasonably allocate its responsibility to close out a fail to deliver position to another broker-dealer from which the participant receives trades for clearance and settlement.[196] Consistent with temporary Rule 204T(d), Rule 204(d) provides for allocation of a fail to deliver position by a participant to a broker-dealer. Specifically, Rule 204(d) provides that if a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker-dealer for which it clears trades or from which it receives trades for settlement, based on such broker-dealer's short position, the provisions of Rule 204(a) and (b) relating to such fail to deliver position shall apply to such registered broker-dealer that was allocated the fail to deliver position, and not to the participant.[197] This allocation provision benefits participants because if a participant can identify the accounts of broker-dealers for which they clear or from which they receive trades for settlement, the participant can allocate the responsibility to close out the fail to deliver position to the particular broker-dealer account(s) whose trading activities caused the fail to deliver position, provided the allocation is reasonable. In this way, the allocated broker-dealer rather than the participant will incur any costs associated with Rule 204's close-out requirement.

In addition, consistent with temporary Rule 204T(d), Rule 204(d) imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements. Thus, under the rule's allocation provision, if the broker-dealer does not comply with the provisions of Rule 204(a), it must immediately notify the participant that it has become subject to the borrowing requirements of Rule 204(b). This notification requirement is intended to let participants know when a broker-dealer from which the participant receives trades for clearance and settlement has become subject to the rule's borrowing requirements. The notification requirement furthers the Commission's goals of limiting fails to deliver and addressing abusive ''naked'' short selling by promoting the prompt and accurate clearance and settlement of transactions involving equity securities. The notification requirement will also help ensure that participants that receive trades for clearance and settlement from broker-dealers will be on notice that the broker-dealer is subject to the borrow requirements of Rule 204(b) until the fail to deliver position has been closed out.

Under Rule 204(e), even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with Rule 204(a), or has not allocated a fail to deliver position to a broker-dealer in accordance with Rule 204(d), a broker-dealer shall not be subject to the requirements of Rule 204(a) or (b) if it purchases or borrows securities, and complies with the conditions set forth in Rule 204(e)(1) through (4), as described in detail in Section III.C. above. We note that, unlike temporary Rule 204T(e), Rule 204(e) permits a broker-dealer to use a borrow, as well as a purchase, to close out a position prior to the applicable close-out date. Rule 204(e), similar to temporary Rule 204T(e), encourages early close-outs of fail to deliver positions, by providing that a broker-dealer can satisfy the rule's close-out requirements by purchasing securities prior to the applicable close-out date provided the broker-dealer complies with certain conditions. In addition, as noted above, Rule 204(e) provides more flexibility than temporary Rule 204T(e) by allowing a broker-dealer to close out a fail to deliver position prior to the applicable close-out date by borrowing, as well as purchasing securities. We believe this ability to borrow, as well as purchase, securities further encourages early close-outs of fail to deliver positions which serves the benefit of promoting our goal of maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, by facilitating the ability to close-out fails faster.

Further, Rule 204(e) is modified from temporary Rule 204T(e)(3)'s provision that the purchase must be of a quantity of securities sufficient to cover the entire amount of the broker-dealer's open short position. The purpose of Rule 204(e) is to encourage broker-dealers to close out fail to deliver positions prior to the applicable close-out date (*i.e.,* T+4 or T+6) by reducing the costs of the early close-out. Requiring a broker-dealer to close out its open fail to deliver position prior to the applicable close-out date is more closely tailored towards achieving that goal than requiring a broker-dealer to close out its open short position prior to the

[193] *See* Rule 204(a)(1).

[194] *See e.g.,* letters from SIFMA; EWT; MFA; State Street; BATS; Wedbush.

[195] Although Rule 204(a)(1) permits borrowing to close out a fail to deliver position resulting from a long sale, broker-dealers must also comply with Rule 203(a) of Regulation SHO. Rule 203(a)(1) provides that, unless an exception applies, ''[i]f a broker or dealer knows or has reasonable grounds to believe that the sale of an equity security was or will be effected pursuant to an order marked 'long,' such broker or dealer shall not lend or arrange for the loan of any security for delivery to the purchaser's broker after the sale, or fail to deliver a security on the date delivery is due.'' 17 CFR 242.203(a).

[196] *See* temporary Rule 204T(d); *see also* 17 CFR 242.203(b)(3)(vi). Rule 203(b)(3)(vi) of Regulation SHO provides that ''[i]f a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this paragraph (b)(3) relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.''

[197] *See* Rule 204(d).

applicable close-out date. Thus, in response to commenters' concerns, in Rule 204(e)(3) we have modified the requirement of temporary Rule 204T(e)(3) to provide that a broker-dealer must purchase or borrow a quantity of securities sufficient to cover the entire amount of that broker-dealer's fail to deliver position at a registered clearing agency in that security on the day of the purchase. Consequently, we believe our incorporation of the conditions of temporary Rule 204T(e), with the noted modifications, facilitates early close-outs of fail to deliver positions.[198]

2. Borrowing Requirements

Under temporary Rule 204T(b), if a participant does not purchase or borrow shares, as applicable, to close out a fail to deliver position in accordance with temporary Rule 204T, the participant violates the close-out requirements of that rule. We are adopting in Rule 204(b) the borrowing requirements of temporary Rule 204T(b), without modification. Accordingly, Rule 204(b) imposes on the participant and on all broker-dealers from which that participant receives trades for clearance and settlement (including introducing and executing brokers) a requirement to borrow or arrange to borrow securities prior to accepting or effecting further short sales in that security. We believe that this borrow requirement is beneficial in that it furthers our goals of reducing fails to deliver by helping to maintain the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling, by promoting the prompt and accurate clearance and settlement of securities transactions.

Specifically, Rule 204(b) provides that the participant and any broker-dealer from which it receives trades for clearance and settlement, including any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,[199] may not accept a short sale order in an equity security from another person, or effect a short sale order in such equity security for its own account, to the extent that the broker-dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security, or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.[200]

Rule 204, like temporary Rule 204T, is aimed at reducing fails to deliver and addressing potentially abusive ''naked'' short selling. To that end, we believe it is appropriate to include in the rule borrowing requirements for broker-dealers, including participants, that sell short a security for which a fail to deliver position has not been closed out in accordance with the requirements of the rule. We believe that the borrowing requirements of Rule 204(b) will help further our goals of reducing fails to deliver by helping to maintain the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling by promoting the prompt and accurate clearance and settlement of securities transactions. In addition, we believe the rule's requirement that participants and broker-dealers from which they receive trades for clearance and settlement borrow or arrange to borrow securities prior to accepting or effecting short sales in the security that has a fail to deliver position that has not been closed out will help continue to ensure that shares will be available for delivery on any additional short sales by settlement date and, thereby, help to avoid additional fails to deliver occurring in the security.

We note that one commenter asked for clarification regarding whether a participant ceases to be subject to the borrow requirements of temporary Rule 204T(b) if a participant no longer has a fail to deliver position at a registered clearing agency due to the participant borrowing the securities or the participant receiving securities from the seller (*e.g.,* in connection with long sales).[201] Temporary Rule 204T(b) imposes short sale borrowing requirements until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency. Thus, under temporary Rule 204T, regardless of whether a participant borrows or receives delivery of securities, the requirements of temporary Rule 204T(b) continue to apply until the participant purchases securities to close out the fail to deliver position and that purchase has cleared and settled at a registered clearing agency.

We have incorporated these same requirements into Rule 204(b) without modification. The provisions of Rule 204(b) are intended to act as an additional incentive to broker-dealers to deliver securities by settlement date, and to close out fail to deliver positions in accordance with the requirements of Rule 204. We believe that the purchase requirement of Rule 204(b) is beneficial in that it will continue to further these goals.

In connection with the borrowing requirements of Rule 204(b), we are incorporating into Rule 204(c) the notification requirement contained in temporary Rule 204T(c), without modification. In accordance with Rule 204(c), participants must notify all broker-dealers from which they receive trades for clearance and settlement that a fail to deliver position has not been closed out in accordance with Rule 204. Specifically, Rule 204(c) provides that the participant must notify any broker-dealer from which it receives trades for clearance and settlement, including any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,[202] (a) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of Rule 204, and (b) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.[203]

We are including this notification requirement in Rule 204(c) so that all broker-dealers that submit trades for clearance and settlement to a participant

[198] *See supra* Section III.C. (explaining the conditions of Rule 204(e), as well as commenters' concerns that by requiring broker-dealers to close-out their entire open short position temporary Rule 204T(e) does not encourage early close-outs).

[199] *See* 17 CFR 242.203(b)(2)(iii) (providing an exception from Regulation SHO's ''locate'' requirement for short sales effected by a market maker in connection with bona fide market making activities in the securities for which the exception is claimed).

[200] *See* Rule 204(b). The borrow requirements of Rule 204(b) are also consistent with the requirements of Rule 203(b)(3)(iv) of Regulation SHO for a participant that has not closed out a fail to deliver position in a threshold security that has persisted for thirteen consecutive settlement days. *See* 17 CFR 242.203(b)(3)(iv). Rule 203(b)(3)(iv) of Regulation SHO provides that ''[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, many not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.''

[201] *See* letter from SIFMA.

[202] *See supra* note 199.

[203] *See* Rule 204(c).

that has a fail to deliver position in a security that has not been closed out in accordance with Rule 204 will be on notice that short sales in that security to be cleared or settled through that participant will be subject to the borrow requirements of Rule 204(b) until the fail to deliver position has been closed out. We believe this notification requirement will help serve the goal of addressing potentially abusive ''naked'' short selling in equity securities.

As noted above, Rule 204(d) provides that a participant may reasonably allocate (*e.g.,* the allocation must be timely) its responsibility to close out a fail to deliver position to another broker-dealer for which the participant clears or from which the participant receives trades for settlement. Thus, to the extent that the participant can identify the broker-dealer(s) that have contributed to the fail to deliver position, and the participant has reasonably allocated the close-out obligation to the broker-dealer(s), the requirement to borrow or arrange to borrow prior to effecting further short sales in that security will continue to apply to only those particular broker-dealer(s).[204]

Rule 204(b) includes an exception from the borrowing requirements for any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. We have incorporated into Rule 204(b) the language of temporary Rule 204T(b)(1), without modification. Thus, Rule 204(b) provides that a broker-dealer shall not be subject to the requirements of paragraph (b) of Rule 204 if the broker-dealer timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that the broker-dealer is in compliance with the requirements of Rule 204(e).[205] We have included this exception because we continue to believe that a broker-dealer should not be subject to the borrowing requirements of the rule if the broker-dealer can demonstrate that it did not incur a fail to deliver position in the security on settlement date, or if it has taken steps, in accordance with Rule 204(e), to close out the fail to deliver position.

Temporary Rule 204T(b)(2) included an exception from the borrowing requirements of temporary Rule 204T(b) for market makers that can demonstrate that they do not have an open short position in the equity security at the time of any additional short sales.[206] We do not believe that a similar exception is necessary under Rule 204(b) because, as with other broker-dealers, a market maker is excepted from the borrowing requirements of Rule 204(b) if it timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that it is in compliance with the requirements of Rule 204(e). Because Rule 204(b) includes an exception applicable to all broker-dealers, including market makers, we do not think it is necessary to maintain a separate exception applicable only to market makers.

3. Sales of Certain Deemed To Own Securities

After considering the comments and to provide consistency between the delivery requirements of Rule 203(b)(2)(ii) of Regulation SHO and the close-out requirements of Rule 204, we are adopting in Rule 204(a)(2) the requirements of temporary Rule 204T(a)(2) with some limited modifications.[207] Specifically, we are expanding the universe of securities to which Rule 204(a)(2) will apply. Rule 204(a)(2) will apply to fails to deliver resulting from the sale of an equity security that a person is ''deemed to own'' pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed.[208] In addition, we are revising the close-out period within which a participant must close out fails to deliver resulting from sales of such securities to be consistent with the delivery period contained in Rule 203(b)(2)(ii) of Regulation SHO.

Thus, Rule 204(a)(2) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security resulting from the sale of a security that a person is deemed to own pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed, the participant shall, by no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.[209] We believe that amending the close-out requirement to 35 consecutive calendar days from trade date for fails to deliver resulting from sales of such owned securities will better permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). In addition, the amendment to the close-out period relieves an inconsistency between Rule 203(b)(2)(ii) of Regulation SHO and temporary Rule 204T(a)(2), as noted by one commenter.[210]

Although this amendment will provide an extended period of time within which fails to deliver resulting from sales of certain ''deemed to own'' securities must be closed out, we believe that such additional time is warranted and does not undermine our goal of reducing fails to deliver because these are sales of owned securities that cannot be delivered by settlement date due solely to processing delays outside the seller's or broker-dealer's control. Moreover, delivery will be made on such sales as soon as all restrictions on delivery have been removed. In addition, if a fail to deliver position is not closed out in accordance with Rule 204(a)(2), the borrowing requirements of Rule 204(b) will apply. Rule 204(b)'s borrowing requirements will help ensure that additional fails to deliver cannot occur until securities have been purchased to close out the fail to deliver position and such purchase has cleared and settled.

Thus, if a participant does not close out a fail to deliver position at a registered clearing agency in accordance with Rule 204(a)(2), the rule prohibits the participant, and any broker-dealer from which it receives trades for clearance and settlement, including market makers, from accepting any short sale orders or effecting further short sales in the particular security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.[211]

C. Costs

We recognize that temporary Rule 204T may have resulted in increased short selling costs for participants that may have impacted legitimate short

[204] *See* Rule 204(d).

[205] *See* Rule 204(b).

[206] *See* temporary Rule 204T(b)(2).

[207] *See e.g.*, letter from SIFMA.

[208] *See* Rule 204(a)(2).

[209] *See id.*

[210] *See* letter from SIFMA.

[211] *See* Rule 204(b).

selling activities.[212] To the extent that the requirements of temporary Rule 204T have resulted in increased short selling costs, we do not believe that such costs will increase, and may in fact decrease, under Rule 204 because, as discussed below, among other things, we have provided additional flexibility to closing out fails to deliver under Rule 204 as compared to Rule 204T.

Some commenters stated that temporary Rule 204T has imposed burdens on market participants in several areas, including on firm operations personnel.[213] Some industry participants have stated that lending rates increased significantly following the adoption of temporary Rule 204T and other recent Commission actions.[214] We note, however, that the evidence that attempts to specify the cause of any such increase in lending rates is confounded by the unusual circumstances of the continued credit crisis. In addition, we note that a recent academic study that examined borrowing costs after the September Emergency Order[215] found no significant increase in average lending rates.[216]

As discussed in more detail below, some commenters also stated that the inflexibility of temporary Rule 204T's requirement that participants purchase securities to close-out a fail to deliver position by no later than the beginning of regular trading hours on the applicable close-out date has led to increased market pressures and market volatility due to the need to execute potentially large purchases at the market open.[217]

To the extent that the requirements of Rule 204 result in increased costs to short selling in equity securities, it may lessen some of the benefits of legitimate short selling and, thereby, result in a reduction in short selling generally. Such a reduction may lead to a decrease in market efficiency and price discovery, less protection against upward stock price manipulations, a less efficient allocation of capital, an increase in trading costs, and a decrease in liquidity. We also recognize that requiring that participants close out fails to deliver in equity securities in accordance with the rule may potentially impact the willingness of participants to provide liquidity. As one commenter stated, certain aspects of the close-out process ''may have an unintended impact on the securities lending market and therefore the efficient functioning of the markets.''[218] As a result, securities lending could become more risky and costly and, in turn, impact market liquidity and price discovery benefits of short selling.[219]

Although we recognize that Rule 204 may result in the continuation of some costs, as well as new costs, to certain participants, as discussed in detail below, we believe such costs will be limited and are justified by the fact that the rule will continue our efforts to achieve our goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling and, thereby help restore, maintain, and enhance investor confidence in the markets.

1. Close-Out Requirements

Consistent with temporary Rule 204T(a), Rule 204(a) provides that a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.[220] Similarly, consistent with temporary Rule 204T(a)(1) and (a)(3), the close-out requirements of Rule 204(a)(1) and (a)(3) for fails to deliver resulting from long sales and certain bona fide market making activity must be closed out by the beginning of regular trading hours on the close-out date for such fails to deliver (*i.e.,* T+6).[221]

As discussed in detail above in Section VII.B. in connection with the benefits of Rule 204, some commenters requested that we extend the close-out period for fails to deliver resulting from short sales, long sales, and bona fide market making activity from the beginning to the end of regular trading hours on the applicable close-out date due to concerns that temporary Rule 204T's requirement to close out fails to deliver by no later than the beginning of regular trading hours can create buying pressure at the open, that may temporarily distort the price of the security.[222] Other commenters requested additional days within which to close out fails to deliver in connection with short sales.[223] Commenters stated that the additional time to close out fails to deliver would allow the majority of trades to clear and settle on their own within a few days following the regular settlement date (*i.e.,* T+3).[224]

Some commenters expressed concerns about the effect of the close-out requirements of temporary Rule 204T on securities lending.[225] One commenter also noted that in practice fails to deliver resulting from sales of securities on loan, which are considered ''long'' sales, are often closed out in accordance with the time-frames for fails to deliver resulting from short sales rather than long sales because temporary Rule 204T does not provide sufficient time to determine whether or not a fail to deliver position resulted from a long or short sale, which acts as a disincentive to lending and causes institutions to question their participation in lending programs.[226] Other commenters expressed concerns regarding the impact of temporary Rule 204T's close-out requirements on the lending recall process.[227]

As discussed above, although we recognize commenters' concerns regarding the potential market impact of the close-out requirements of temporary Rule 204T, such close-out requirements are furthering our goal of reducing fails to deliver, as evidenced in part by preliminary results from OEA regarding its impact on the number of fails to

[212] *See, e.g.,* letter from CBOE (noting its belief that legitimate short selling activity has been damaged by temporary Rule 204T).

[213] *See* letters from CBOE (stating that temporary Rule 204T has created undue burdens in trading and risk management, clearing, lending and buy-in operations and front-end trading, back-office and regulatory systems); SIFMA; State Street (noting the ''additional transactional, operational and market costs which the industry had to incur'').

[214] *See supra* notes 39–42 and accompanying text (discussing recent Commission actions in addition to the adoption of temporary Rule 204T).

[215] *See* September Emergency Order, 73 FR 54875.

[216] *See* Adam C. Kolasinski, Adam V. Reed, and Jacob R. Thornock, *Prohibitions versus Constraints: The 2008 Short Sales Regulations,* March 2009 working paper.

[217] *See e.g.,* letters from SIFMA; MFA; Wedbush; Lek Securities; State Street.

[218] Letter from ICI; *see also* letter from CBOE.

[219] *See* letters from ICI; BATS.

[220] *See* Rule 204(a).

[221] *See* Rules 204(a)(1) and 204(a)(3).

[222] *See, e.g.,* letters from MFA; CBOE; SIFMA; BATS; RMA; State Street.

[223] *See e.g.,* letters from EWT; Coalition of Private Investment Companies; SIFMA; MFA; State Street; CBOE; Options Exchanges.

[224] *See, e.g.,* letters from SIFMA; MFA; State Street; CBOE; Options Exchanges; Coalition of Private Investment Companies.

[225] *See, e.g.,* letter from SIFMA.

[226] *See* letter from SIFMA; *see also* letters from RMA; ICI.

[227] *See* letters from EWT; BATS; RMA; ICI; Wedbush; RMA.

deliver.[228] To maintain this reduction, we believe it is appropriate at this time to adopt as a permanent rule the requirement that fails to deliver resulting from short sales, long sales, and certain bona fide market making activity must be closed out by no later than the beginning of regular trading hours on the applicable close-out date.

In addition, as discussed above, we believe that continuing to require that fails to deliver be closed out on the day immediately following the day on which the fail to deliver occurs is consistent with our goal of reducing fails to deliver and addressing ''naked'' short selling and, in particular, potentially abusive ''naked'' short selling. Although extending the time-frames within which fails to deliver must be closed out may allow for ordinary course settlement, as several commenters contend, we believe that the close-out requirements of Rule 204 are necessary to help encourage delivery by settlement date and achieve our goal of not allowing fails to deliver to persist.

We recognize that Rule 204T's close-out requirement resulted in costs for participants of a registered clearing agency in terms of systems and surveillance modifications and recordkeeping, as well as changes to processes and procedures. Because we have made limited modifications in Rule 204 to some of the requirements of temporary Rule 204T, compliance with Rule 204's requirements may result in new costs for participants in terms of systems and surveillance modifications and recordkeeping, as well as changes to processes and procedures.

We believe, however, that most of the infrastructure and personnel necessary to comply with Rule 204 is already in place to meet the requirements of Rule 203(b)(3) of Regulation SHO[229] and temporary Rule 204T. As temporary Rule 204T has been in effect since September 2008, and Rule 204 incorporates the substance of temporary Rule 204T with limited modifications, market participants should already have established systems and processes that should mitigate many of the costs to comply with Rule 204. Thus, we believe any additional costs incurred with respect to complying with Rule 204's close-out requirements, over those incurred with respect to complying with temporary Rule 204T, will be minimal.

In addition, we note that the close-out requirements of Rule 204 are consistent with current settlement practices and procedures and with the close-out requirements of temporary Rule 204T and Rule 203(b)(3) of Regulation SHO. For example, because most transactions settle by T+3, participants should already have had in place policies and procedures to help ensure that delivery is being made by settlement date prior to the implementation of the requirements of temporary Rule 204T.[230] Nevertheless, under Rule 204, as under temporary Rule 204T, we recognize that participants will continue to incur costs for each close-out and these costs could accumulate to significant amounts over time and across participants. For example, one commenter noted that ''the close-out process is manual in nature and involves intensive monitoring of multiple levels of data across various system platforms and business units within the firm.''[231] We believe, however, that the experience participants have gained to date in complying with temporary Rule 204T is expected to reduce the costs to participants in complying with Rule 204 from those incurred in connection with complying with Rule 204T.

Moreover, similar to the existing close-out requirements of Rule 203(b)(3) of Regulation SHO and consistent with temporary Rule 204T, the requirements of Rule 204 are based on a participant's fail to deliver position at a registered clearing agency. As noted above, the NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter markets.[232] The NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members.[233] The NSCC notifies its members of their securities delivery and payment obligations daily.[234] Because Rule 204 is based on a participant's fail to deliver position at a registered clearing agency, it is consistent with current settlement practices and procedures and with the Regulation SHO framework regarding delivery of securities.[235] As such, we anticipate that most participants will already have systems, processes and procedures in place in order to comply with Rule 204's close-out requirements and, therefore, that any additional implementation costs associated with the rule will be minimal.

In addition, to comply with Regulation SHO's close-out requirement when it became effective in January 2005, participants needed to modify their recordkeeping systems and surveillance mechanisms.[236] Participants also should have retained and trained the necessary personnel to ensure compliance with the Regulation SHO's close-out requirements. As we noted in the Rule 204T Adopting Release, the infrastructure necessary to comply with the requirements of that rule should already be in place.[237] Because Rule 204 incorporates the substance of temporary Rule 204T with limited modifications, we similarly believe that most of the infrastructure necessary to comply with Rule 204's close-out requirements will already be in place. Thus, we believe minimal modifications will be necessary to comply with Rule 204. Accordingly, we believe that any changes to personnel, computer hardware and software, recordkeeping or surveillance costs will be minimal.[238]

We recognize that the requirements of Rule 204(a)(1) with respect to closing out fails to deliver resulting from long sales, may impose additional costs on participants. However, we believe that these costs are consistent with those currently borne by these entities in complying with temporary Rule 204T(a)(1). Under Rule 204(a)(1), a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in an equity security and can demonstrate on its books and records that the fail to deliver position resulted from a long sale will have until no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date to immediately close out the fail to deliver position by purchasing or borrowing securities of like kind and quantity.[239] Thus, to qualify for this additional time to close out a fail to deliver position, the rule requires the participant to demonstrate on its books and records that the fail to deliver position resulted from a long sale. This demonstration requirement may result in participants continuing to incur costs related to personnel, recordkeeping, systems, and surveillance mechanisms. However, because most of these systems have been in place since September 2008 in order for broker-dealers to comply with the requirements of temporary Rule

[228] *See supra* note 164.

[229] *See* 17 CFR 242.203(b)(3).

[230] *See supra* note 16.

[231] Letter from SIFMA.

[232] *See supra* note 35.

[233] *See id.*

[234] *See id.*

[235] *See* 17 CFR 242.203(b)(3).

[236] *See, e.g.,* letter from SIFMA (indicating that their existing system for tracking and eliminating fails to deliver is based on the Regulation SHO framework).

[237] *See* Rule 204T Adopting Release, 73 FR 61725.

[238] *See also supra* Section VII.B.I. (discussing benefits of the close-out requirements despite commenters' costs concerns).

[239] *See* Rule 204(a)(1).

204T, we do not believe that the demonstration requirements of Rule 204(a)(1) will result in significant additional cost.

In addition, we recognize that the allocation notification requirement of Rule 204(d) may continue to impose costs on broker-dealers that have been allocated responsibility for the close-out requirement under the rule. As discussed above, consistent with temporary Rule 204T(d), Rule 204(d) requires a broker-dealer that has been allocated a portion of a fail to deliver position that has not complied with the close-out requirements under the rule to notify the participant that it has become subject to the borrowing requirements of Rule 204(b). This notification requirement may result in broker-dealers incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. Again, as most of these mechanisms have been in place since the implementation of temporary Rule 204T, we believe any further implementation costs will be minimal, and the costs incurred with each notification will be similar to those incurred under temporary Rule 204T.

We also recognize that like temporary Rule 204T, the requirements of Rule 204(e) may continue to impose costs on broker-dealers. Rule 204(e) allows a broker-dealer to obtain credit if it purchases securities in accordance with the conditions specified in that provision of the rule. Rule 204(e) requires, among other things, that a broker-dealer demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker-dealer is claiming credit. This demonstration requirement may continue to result in participants incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. However, we believe the costs associated with Rule 204(e) will be minimal because the mechanisms necessary to comply with this requirement should already be in place.

2. Borrowing Requirements

Consistent with temporary Rule 204T, we believe that Rule 204's borrowing requirements for fail to deliver positions that are not closed out in accordance with the rule will result in limited, if any, implementation costs—in terms of personnel, recordkeeping, systems and surveillance mechanisms—to participants of a registered clearing agency, and broker-dealers from which they receive trades for clearance and settlement. These entities have already had to comply with the borrowing requirements of Rule 203(b)(3)(iv) of Regulation SHO,[240] since January 2005, and temporary Rule 204T since September 2008, as applicable, if a fail to deliver position has not been closed out in accordance with those rules' mandatory close-out requirements. Accordingly, participants and broker-dealers are already required to have in place the personnel, recordkeeping, systems, and surveillance mechanisms necessary to comply with Rule 204(b)'s borrowing requirements. Nevertheless, we recognize that these borrowing requirements will impose costs on participants, broker-dealers, and investors, and these costs can accumulate to significant amounts if the borrowing requirement is triggered often. One commenter stated a concern that, ''[R]equiring a borrow or arrangement to borrow securities prior to accepting or effectuating further short sales in a security that failed to deliver and has not been closed out, are overly restrictive.'' [241] Because Rule 204 does not modify this requirement, we expect these costs to be similar to those under temporary Rule 204T.

Consistent with temporary Rule 204T, however, Rule 204 is aimed at addressing potentially abusive ''naked'' short selling. To that end, we believe it is appropriate to continue to include in the rule borrowing requirements for participants and broker-dealers that sell short a security for which a fail to deliver position has not been closed out in accordance with the requirements of the rule. We believe that the borrowing requirements of Rule 204(b), like those already required by temporary Rule 204T(b), will help further our goals of reducing fails to deliver by helping to maintain the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling by promoting the prompt and accurate clearance and settlement of securities transactions. By continuing to require that participants and broker-dealers from which they receive trades for clearance and settlement borrow or arrange to borrow securities prior to accepting or effecting additional short sales in the security that has a fail to deliver position that has not been closed out, the rule will continue to help ensure that shares will be available for delivery on the short sale by settlement date and, thereby, will continue to help avoid additional fails to deliver occurring in the security.

Moreover, we believe any other costs incurred in connection with the borrowing requirements of Rule 204(b) will be limited because, consistent with temporary Rule 204T(b)(1), if a participant becomes subject to the borrowing requirements of Rule 204(b), a broker-dealer that clears through the participant will not also be subject to the borrowing requirements of Rule 204(b) if that broker-dealer can demonstrate that it was not responsible for any part of the fail to deliver position of the participant or that it has complied with the requirement of Rule 204(e).[242]

The certification requirement of Rule 204(b) may impose some costs on a broker-dealer having to demonstrate that it was not responsible for any part of the fail to deliver position of the participant. As discussed above, Rule 204(b) requires a broker-dealer to timely certify to the participant that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or the broker-dealer is in compliance with the requirements set forth in Rule 204(e).[243] However, as we noted in the PRA section for temporary Rule 204T, the certification requirement's impact on broker-dealers' costs related to personnel, recordkeeping, systems, and surveillance mechanisms is expected to be limited.[244] We expect that Rule 204's impact on broker-dealers' costs similarly will be limited because the requirements of Rule 204(b) are consistent with the requirements of temporary Rule 204T(b)(1).

Consistent with existing requirements under temporary Rule 204T(c), the notification requirement of Rule 204(c) may continue to impose costs on participants of a registered clearing agency. Rule 204(c) requires a participant to notify any broker-dealer from which it receives trades for clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,[245] (1) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of Rule 204(a), and (2) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered

[240] 17 CFR 242.203(b)(3)(iv).

[241] Letter from MFA.

[242] *See* Rule 204(b).

[243] *See id.*

[244] *See* Rule 204T Adopting Release, 73 FR 61726–61727.

[245] *See supra* note 199.

clearing agency.[246] This notification requirement may result in participants incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. We believe, however, that any additional costs under Rule 204 will be minimal because participants should already have in place mechanisms necessary to comply with this requirement pursuant to temporary Rule 204T.

3. Sales of Certain Deemed To Own Securities

We do not believe that the modification in Rule 204(a)(2) to apply the close-out requirement to fails to deliver resulting from the sale of any equity security that a person is ''deemed to own'' pursuant to Rule 200 of Regulation SHO, and that such person intends to deliver as soon as all restrictions on delivery have been removed, rather than just fails to deliver resulting from sales of Rule 144 Securities as in temporary Rule 204T(a)(2), will impose any significant additional cost on participants.[247] In fact, this modification is responsive to issues raised by commenters and should decrease costs from those of temporary Rule 204T by providing additional time to close out fails to deliver in additional ''deemed to own'' securities.[248]

Participants may incur some costs to implement changes to their current systems to comply with the limited modifications in Rule 204(a)(2) as compared with temporary Rule 204T(a)(2). Specifically, participants will have to ensure that their systems apply the close-out requirements to all ''deemed to own'' securities, rather than just equity securities sold pursuant to Rule 144 of the Securities Act, as well as monitor for compliance with the 35 calendar day close-out period. However, we believe the costs for such adjustments will be minimal.

VIII. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.[249] In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.[250] Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe Rule 204 will not materially affect the promotion of the efficiency of the capital markets. Rule 204 makes some modifications relative to temporary Rule 204T and we believe that Rule 204 will help limit disruptions due to potentially abusive ''naked'' short selling, but several commenters argue that temporary Rule 204T created disruptions at the open and empirical evidence suggests that fails to deliver, on average, are unrelated to stock prices.[251]

As discussed in the Rule 204T Adopting Release, we believe that Rule 204 will help further our goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling without unduly burdening legitimate short selling activity. Rule 204 is intended to maintain the significant reductions in the number of fails to deliver in all equity securities since, among other actions, the adoption of temporary Rule 204T[252] by requiring that participants of a registered clearing agency that have a fail to deliver position, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity by no later than the beginning of regular trading hours on the applicable close-out date. A participant that does not comply with Rule 204's close-out requirements, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security either for itself or for the account of another, unless it has borrowed the security, or entered into a bona fide arrangement to borrow the security, until the fail to deliver position is closed out.

The rule is designed to help ensure that buyers of equity securities receive delivery of their shares, thereby helping to discourage persistent fails to deliver, which may have a negative effect on the securities markets and investors and also may be used to facilitate manipulative trading strategies. By requiring that participants of a registered clearing agency borrow or purchase securities to close out a fail to deliver position by no later than the beginning of regular trading hours on the applicable close-out date, Rule 204 will promote the prompt clearance and settlement of securities transactions. By doing so, the rule will help further our goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling and, thereby, will help ensure that investors remain confident that trading can be conducted without the illegal influence of manipulation. A loss of confidence in the market for these securities can lead to panic selling, which may be further exacerbated by potentially abusive ''naked'' short selling.

We sought comment regarding whether the rule may adversely impact liquidity, disrupt markets, or unnecessarily increase risks or costs to participants of a registered clearing agency. We are incorporating by reference the discussion in the Rule 204T Adopting Release regarding the burden on competition and promotion of efficiency, competition, and capital formation,[253] except to the extent that we have made modifications or because we are addressing comments.

Several commenters suggested that temporary Rule 204T has had a negative impact, particularly at the market open.[254] Although we recognize commenters' concerns regarding the potential market impact of the close-out requirements of temporary Rule 204T, we believe that these potential concerns are justified by the benefits of retaining the strict close-out requirements of temporary Rule 204T. In addition, we note that the close-out provisions of Rule 204 provide additional flexibility in 204(a)(1) and (a)(3) by allowing a participant to close out a fail to deliver position resulting from a long sale or certain bona fide market making activity by borrowing as well as purchasing securities. In addition, as discussed above, in contrast to temporary Rule 204T, participants may satisfy the close-out requirement to purchase securities of like kind and quantity with a VWAP order.[255] This increased flexibility in

[246] *See* Rule 204(c).

[247] *See* Rule 204(a)(2).

[248] *See, e.g.,* letter from SIFMA.

[249] 15 U.S.C. 78c(f).

[250] 15 U.S.C. 78w(a)(2).

[251] *See, e.g.,* Fotak, Raman, and Yadav, 2009, Naked Short Selling: The Emperor's New Clothes?, working paper, University of Oklahoma.

[252] *See supra* note 164.

[253] *See* Rule 204T Adopting Release, 73 FR 61728–61729.

[254] *See supra* Section III (discussing commenters' concerns regarding the market impact of temporary Rule 204T).

[255] *See supra* note 66.

Rule 204, as compared with temporary Rule 204T, is expected to reduce the possibility of the increased volatility and market disruptions potentially caused by temporary Rule 204T by potentially providing additional sources of liquidity from which to obtain shares to close out fail to deliver positions.

We believe that the rule will promote capital formation. Issuers and investors have repeatedly expressed concerns about fails to deliver in connection with potentially manipulative ''naked'' short selling.[256] The perception that potentially abusive ''naked'' short selling is occurring in securities could undermine the confidence of investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.[257] To the extent that ''naked'' short selling and fails to deliver result in an unwarranted decline in investor confidence about a security, the rule will improve investor confidence about the security. As previously noted, preliminary results from OEA indicate that the Commission's various recent actions with respect to further reducing fails to deliver, including the adoption of temporary Rule 204T, have contributed to a significant reduction in the number of fails to deliver.[258] In addition, the rule may lead to a greater certainty in the settlement of these securities which is expected to strengthen investor confidence in the settlement process. Therefore, we believe maintaining the substance of temporary Rule 204T in permanent Rule 204 will help achieve the Commission's goals of preventing substantial disruption in the securities markets, reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and helping to prevent potentially abusive ''naked'' short-selling.

We also believe that the rule will not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. By requiring that participants of a registered clearing agency borrow or purchase securities to close out a fail to deliver position by no later than the beginning of regular trading hours on the applicable close-out date, we believe the rule will promote competition by requiring similarly situated participants of a registered clearing agency, including broker-dealers from which they receive trades for clearance and settlement, to close out fail to deliver positions in any equity securities within similar time-frames. Moreover, the requirements of the rule will help to further reduce any possibility that potentially abusive ''naked'' short selling may contribute to the disruption of markets in equity securities and, therefore, will help ensure that all investors remain confident that trading in these securities can be conducted without the influence of illegal manipulation. We also believe that the rule will promote competition by protecting and enhancing the operation, integrity, and stability of the markets. At the same time, the rule will help to maintain fair and orderly markets without unduly restricting legitimate short selling.

IX. Final Regulatory Flexibility Analysis

The Final Regulatory Flexibility Analysis (''FRFA'') has been prepared in accordance with 5 U.S.C. 604. This FRFA relates to the adoption of Rule 204 to Regulation SHO.[259]

A. Need for and Objectives of the Rule

Sections I through VI of this release describe the reasons for and objectives of Rule 204. As previously stated in the temporary Rule 204T Adopting Release,[260] we are concerned that the close-out requirements of Regulation SHO have not gone far enough in reducing fails to deliver and addressing potentially abusive ''naked'' short selling. Thus, we are incorporating the requirements of temporary Rule 204T with limited modification into Rule 204 to help maintain the recent reductions in fails to deliver resulting from the implementation of temporary Rule 204T and other Commission actions. We believe the adoption of Rule 204 is appropriate to continue our goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, addressing potentially abusive ''naked'' short selling, and providing an incentive for sellers to promptly deliver securities by settlement date.

B. Small Entities Affected by the Rule

The entities covered by the rule will include small entities that are participants of a registered clearing agency and small broker-dealers from which participants receive trades for clearance and settlement. In addition, the entities covered by the rule will include small entities that are market participants that effect sales subject to the requirements of Regulation SHO. Although it is impossible to quantify every type of small entity covered by the rule, Paragraph (c)(1) of Rule 0–10 under the Exchange Act[261] states that the term ''small business'' or ''small organization,'' when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than $500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to § 240.17a–5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. We estimate that as of 2008 there were approximately 915 broker-dealers that qualified as small entities as defined above.[262]

As noted above, the entities covered by the rule will include small entities that are participants of a registered clearing agency. As of May 30, 2009, approximately 89% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO.

[256] *See, e.g.,* 2008 Regulation SHO Final Amendments, 73 FR 61690.

[257] *See supra* note 28 (discussing comments in response to the Rule 204T Adopting Release expressing concern about the impact of potential ''naked'' short selling on capital formation, claiming that ''naked'' short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets). In connection with prior proposed amendments to Regulation SHO aimed at reducing fails to deliver and addressing potentially abusive ''naked'' short selling, such as the 2007 Regulation SHO Proposed Amendments, we sought comment on whether such proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors' decisions to invest in certain equity securities. In response, commenters expressed concern about the potential impact of ''naked'' short selling on capital formation claiming that ''naked'' short selling causes a drop in an issuer's stock price that may limit the issuer's ability to access the capital markets. *See, e.g.,* letters from Medis; NCANS.

[258] *See supra* note 164.

[259] Although the requirements of the Regulatory Flexibility Act are not applicable to rules adopted under the Administrative Procedure Act's ''good cause'' exception, see 5 U.S.C. 601(2) (defining ''rule'' and notice requirements under the Administrative Procedures Act), we nevertheless prepared an FRFA.

[260] *See* Rule 204T Adopting Release, 73 FR 61712.

[261] 17 CFR 240.0–10(c)(1).

[262] These numbers are based on OEA's review of 2008 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

The Federal securities laws do not define what is a ''small business'' or ''small organization'' when referring to a bank. The Small Business Administration regulations define ''small entities'' to include banks and savings associations with total assets of $175 million or less.[263] As of May 30, 2009, no bank that was a participant of the NSCC was a ''small entity'' because none met that criteria.

Paragraph (e) of Rule 0–10 under the Exchange Act [264] states that the term ''small business'' or ''small organization,'' when referring to an exchange, means any exchange that: (1) Has been exempted from the reporting requirements of Rule 601 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0–10. No U.S. registered exchange is a small entity because none meets these criteria.

Paragraph (d) of Rule 0–10 under the Exchange Act [265] states that the term ''small business'' or ''small organization,'' when referring to a clearing agency, means a clearing agency that: (1) Compared, cleared and settled less than $500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter); (2) had less than $200 million in funds and securities in its custody or control at all times during the preceding fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined by Rule 0–10. No clearing agency that is subject to the requirements of Regulation SHO is a small entity because none meets these criteria.

C. Projected Reporting, Recordkeeping and Other Compliance Requirements

The rule may impose some new or additional reporting, recordkeeping, or compliance costs on small entities that are participants of a clearing agency registered with the Commission and small broker-dealers from which the participant receives trades for clearance and settlement. We do not believe, at this time, that any specialized professional skills will be necessary to comply with the rule.

D. Agency Action To Minimize Effect on Small Entities

As required by the Regulatory Flexibility Act, we have considered alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Rule 204 is not expected to adversely affect small entities because it imposes minimal reporting, record keeping, or compliance requirements, many of which were previously required of small entities pursuant to the implementation of Regulation SHO and, more recently, temporary Rule 204T. Moreover, it is not appropriate to develop separate requirements for small entities because we believe that to accomplish the Commission's stated goals, all broker-dealers, regardless of size, should be subject to the same enhanced delivery requirements imposed by the rule.

E. Duplicative, Overlapping, or Conflicting Federal Rules

The Commission believes that there are no rules that duplicate, overlap, or conflict with Rule 204. The Commission has designed the rule so that it is consistent with the close-out requirements of Rule 203(b)(3) of Regulation SHO. In addition, with limited modifications to address commenters' concerns, Rule 204 incorporates the substance and maintains most of the components of temporary Rule 204T of Regulation SHO and will become effective on July 31, 2009, the expiration date for temporary Rule 204T.

F. Significant Alternatives

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities.[266] In connection with the rule, we considered the following alternatives: (1) Establishing different compliance or reporting standards or timetable that take into account the resources available to small entities; (2) clarifying, consolidating, or simplifying compliance requirements under the rule for small entities; (3) using performance rather than design standards; and (4) exempting small entities from coverage of the rule, or any part of the rule.

The rule furthers the Commission's stated goal of helping to eliminate the possibility that potentially abusive ''naked'' short selling may contribute to disruption in the securities markets and, therefore, to help ensure that investors remain confident that trading in equity securities can be conducted without the illegal influence of manipulation. The rule also furthers the goals of helping to maintain fair and orderly markets against the threat of sudden and excessive fluctuations of securities prices generally.

The rule should not adversely affect small entities because the rule will impose only minimal compliance requirements, many of which were previously required of small entities pursuant to the implementation of Regulation SHO and, more recently, temporary Rule 204T. Moreover, it is not appropriate to develop different compliance requirements for small entities with respect to the rule because we believe all entities, including small entities, should be subject to the requirements of the rule. We believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the Commission's goals of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by the adoption of temporary Rule 204T, as well as other actions taken by the Commission, and addressing potentially abusive ''naked'' short selling. We have concluded similarly that it is not consistent with the goal of the rule to further clarify, consolidate or simplify the rule for small entities. The Commission also believes that it is inconsistent with the purposes of the Exchange Act to exempt small entities from having to comply with the rule.

X. Statutory Authority

Pursuant to the Exchange Act and, particularly, Sections 2, 9(h), 10, 11A, 15, 17, 17A, and 23(a) thereof, 15 U.S.C. 78b, 78i(h), 78j, 78k–1, 78o, 78q, 78q–1, and 78w(a), the Commission is amending Regulation SHO to adopt Rule 204.

XI. Text of Amendments

List of Subjects

17 CFR Part 200

Administrative practice and procedure, Authority delegations (Government agencies).

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

■ For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

[263] *See* 13 CFR 121.201.

[264] 17 CFR 240.0–10(e).

[265] 17 CFR 240.0–10(d).

[266] *See* 5 U.S.C. 603(c).

PART 200—ORGANIZATION; CONDUCT AND ETHICS; AND INFORMATION AND REQUESTS

■ 1. The authority citation for Part 200, Subpart A, continues to read in part as follows:

Authority: 15 U.S.C. 77o, 77s, 77sss, 78d, 78d–1, 78d–2, 78w, 78*ll*(d), 78mm, 80a–37, 80b–11, and 7202, unless otherwise noted.

* * * * *

■ 2. Section 200.30–3 is amended by adding paragraph (a)(11) to read as follows:

§ 200.30–3 Delegation of authority to Director of Division of Trading and Markets.

* * * * *

(a) * * *

(11) Upon written application or upon its own motion, either unconditionally or on specified terms and conditions, to grant or deny by order an exemption from the requirements of Regulation SHO (§ 242.200 of this chapter) under the Act pursuant to Section 36 of the Act (15 U.S.C. 78mm).

* * * * *

PART 242—REGULATIONS M, SHO, ATS, AC, AND NMS AND CUSTOMER MARGIN REQUIREMENTS FOR SECURITY FUTURES

■ 3. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78g(c)(2), 78i(a), 78j, 78k–1(c), 78*l*, 78m, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd–1, 78mm, 80a–23, 80a–29, and 80a–37.

■ 4. Section 242.204 is added to read as follows:

§ 242.204 Close-out requirement.

(a) A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity; *Provided, however:*

(1) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security and the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, immediately close out the fail to deliver position by purchasing or borrowing securities of like kind and quantity;

(2) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security resulting from a sale of a security that a person is deemed to own pursuant to § 242.200 and that such person intends to deliver as soon as all restrictions on delivery have been removed, the participant shall, by no later than the begining of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity; or

(3) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security that is attributable to bona fide market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, immediately close out the fail to deliver position by purchasing or borrowing securities of like kind and quantity.

(b) If a participant of a registered clearing agency has a fail to deliver position in any equity security at a registered clearing agency and does not close out such fail to deliver position in accordance with the requirements of paragraph (a) of this section, the participant and any broker or dealer from which it receives trades for clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in § 242.203(b)(2)(iii), may not accept a short sale order in the equity security from another person, or effect a short sale in the equity security for its own account, to the extent that the broker or dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security, or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency; *Provided, however:* A broker or dealer shall not be subject to the requirements of this paragraph if the broker or dealer timely certifies to the participant of a registered clearing agency that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that the broker or dealer is in compliance with paragraph (e) of this section.

(c) The participant must notify any broker or dealer from which it receives trades for clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in § 242.203(b)(2)(iii):

(1) That the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of paragraph (a) of this section; and

(2) When the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.

(d) If a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or from which it receives trades for settlement, based on such broker's or dealer's short position, the provisions of paragraphs (a) and (b) of this section relating to such fail to deliver position shall apply to such registered broker or dealer that was allocated the fail to deliver position, and not to the participant. A broker or dealer that has been allocated a portion of a fail to deliver position that does not comply with the provisions of paragraph (a) of this section must immediately notify the participant that it has become subject to the requirements of paragraph (b) of this section.

(e) Even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with paragraph (a) of this section, or has not allocated a fail to deliver position to a broker or dealer in accordance with paragraph (d) of this section, a broker or dealer shall not be subject to the requirements of paragraph (a) or (b) of this section if the broker or dealer purchases or borrows the securities, and if:

(1) The purchase or borrow is bona fide;

(2) The purchase or borrow is executed after trade date but by no later than the end of regular trading hours on settlement date for the transaction;

(3) The purchase or borrow is of a quantity of securities sufficient to cover the entire amount of that broker's or

dealer's fail to deliver position at a registered clearing agency in that security; and

(4) The broker or dealer can demonstrate that it has a net flat or net long position on its books and records on the day of the purchase or borrow.

(f) A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this section where the participant enters into an arrangement with another person to purchase or borrow securities as required by this section, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase or borrow.

(g) *Definitions.* (1) For purposes of this section, the term *settlement date* shall mean the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.

(2) For purposes of this section, the term *regular trading hours* has the same meaning as in Rule 600(b)(64) of Regulation NMS (17 CFR 242.600(b)(64)).

Dated: July 27, 2009.

By the Commission.

Elizabeth M. Murphy,

Secretary.

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