

Montreal, April 10, 2025

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Re: Interactive Brokers Canada, Inc.'s Comments Regarding Question 12 of the Proposed Amendments Respecting Mandatory Close-Out Requirements

Question 12. SEC Rule 204 in Regulation SHO allows broker dealers that have not closed out fail-to-deliver positions to continue short selling as long as they pre-borrow for themselves or their clients in the affected security. Would this outcome be appropriate for Canada, or should we consider restricting short selling altogether where there is a failure to deliver?

SUMMARY - Interactive Brokers Canada Inc. (“Interactive Brokers” or the “Firm”) does not recommend either of these proposed approaches.

Specifically:

• **Interactive Brokers does not recommend adopting Rule 204 of Regulation SHO.**

As set forth in further detail below, SEC Rule 204 of Regulation SHO presented such challenging operational and interpretative issues for industry participants that the SEC effectively had to rewrite that rule by issuing multiple rounds of further guidance over the course of the decade initially became effective.

Further, imposing Rule 204 closeout obligations on Canadian brokers could result in absurd consequences where brokers must conduct closeout purchases even if neither the broker nor its clients hold short positions, due to differences in how brokers settle on-exchange stock trades versus how brokers settle delivery obligations arising from option exercises and assignments.

• **Interactive Brokers recommends allowing brokers that have not closed out failures-to-deliver to continue short selling subject to a market-based fee, rather than restricting short selling altogether.**

Interactive Brokers recommends allowing brokers that have not closed out a fail-to-deliver (“FTD”) to continue short selling so long as they pay fees for any FTD not cured within a reasonable time period. As set forth below, the Firm believes this market-based mechanism would, among other things, improve market structure by permitting sell-side liquidity to markets as necessary (compared to a blanket prohibition on short sales), while also financially incentivizing brokers to close FTDs as soon as possible.

I. The Firm does not recommend adopting Rule 204 of Regulation SHO, which did not provide adequate guidance to brokers on how to comply with closeout obligations and generated substantial regulatory uncertainty.

At the outset, the Firm does not recommend adopting Rule 204 of Regulation SHO because that rule – as originally implemented in 2009¹ – did not provide adequate guidance to brokers on how to comply with its closeout obligations. For example:

¹ Rule 204 was initially adopted on a temporary basis, at the height of the financial crisis, in October 2008 as Rule 204T, and made permanent in July 2009 as Rule 204 (in only slightly different form than Rule 204T).

- Rule 204 does not permit a broker to use purchases or borrows over multiple days to satisfy or “claim credit” toward satisfying an FTD. This was only permitted by virtue of a substantial rewrite in the form of a No-Action relief².
- Rule 204 does not permit a broker to use multiple rolling closeout purchases to satisfy or partially satisfy an FTD³.
- Rule 204 does not provide sufficient guidance on how a broker needed to allocate shares to reduce a close-out obligation⁴.
- Rule 204 requires a broker, on any day on which it has a closeout obligation, to end the day as a net purchaser — in the aggregate across all of the broker’s activity both for its own account and on behalf of its clients — in an amount at least equal to its closeout obligation that day. This produces the absurd result that on any day that the broker has a closeout obligation, it must potentially stand ready to purchase for its own account the full quantity of any long sale its customers may want to engage in. This was only cured by virtue of a second substantial rewrite in the form of further No-Action relief⁵.
- Rule 204 does not provide guidance on whether a broker could use in-kind ETF creations (where a participant delivers a basket of underlying securities, including the failed security, to the ETF) to satisfy closeout requirements⁶.

From its inception in 2008 to the present, Rule 204 presented such extensive operational and interpretative issues for industry participants that the SEC has effectively rewritten Rule 204 several times by issuing complex guidance that extends Rule 204 far beyond its original language. The Firm has attached examples of such guidance as Exhibits A, B, and C to show how difficult it is for brokers to interpret and comply with Rule 204 on its own terms.

² See Exhibit A, Re: Request for No-Action Relief with Respect to Multi-day Pre-fail and Post-fail Credit under Rule 204 of Regulation SHO (TP File No. 13-11), dated September 6, 2013.

³ *Id.*

⁴ *Id.*

⁵ See Exhibit B, Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Certain Subsequent Trading Activity on a Close-Out Date TP File No. 15-03, dated October 27, 2014.

⁶ See Exhibit C, Re: Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Creations of Covered ETF Shares for Close-Out Purposes and for Confirmation regarding the Treatment of Executed Creations and Executed Redemptions of Covered ETF Shares for Pre-Fail and Post-Fail Credit Purposes under the Multi-Day Close-Out Credit Letter (TP File No. 17-08), dated April 26, 2017.

Despite this guidance – and the publication of multiple, lengthy, FAQs regarding the interpretation of Rule 204 and compliance with that rule – Rule 204 continues to generate substantial regulatory uncertainty that creates a minefield for brokers to commit potential technical violations. Accordingly, Interactive Brokers does not recommend adopting Rule 204.

II. Imposing Rule 204 closeout obligations could result in absurd consequences where brokers would be required to conduct closeout purchases even when those brokers and their customers do not hold short positions.

Rule 204’s closeout obligations are inconsistent with Canadian brokers’ settlement processes and systems, and imposing such obligations on brokers would result in absurd consequences where brokers would be required to execute closeout purchases even when those brokers and their customers do not hold short positions.

Suppose, for example, that a broker’s customer starts the day with only a cash position in his account. The customer then takes the following actions, all on the same day:

1. Buys one contract of a call option for stock ABC;
2. Exercises the call option; and
3. Sells 100 shares of ABC.

In sum, that customer bought 100 shares of ABC via the call exercise and then sold 100 shares of ABC. Accordingly, the customer should end the day in a net flat position with respect to ABC shares.

However, stocks settling from exchange trades (e.g., the sale of 100 shares of ABC here) are generally settled through the Canadian Depository for Securities’ (“CDS”) Continuous Net Settlement system (“CNS”), whereas option exercise and assignment (e.g., the purchase of 100 shares of ABC resulting from the customer’s exercise of his call option) settles through the Canadian Derivatives Clearing Corporation (“CDCC”) (and are not netted against other activity in CNS).

In this example, the broker would be obligated to deliver 100 shares of ABC to CNS due to the customer’s sale of those shares but would not be able to net that delivery obligation against the 100 shares that the broker is supposed to receive from the customer’s exercise

of his call option (since those 100 shares settle separately at CDS). Thus, the broker could wind up with a fail-to-receive (“FTR”) at CDCC (if the assigned party failed to deliver) and a fail-to-deliver at CNS. If the FTR at CDCC persisted (and thus the FTD at CNS persisted), the broker would find itself obligated to conduct a closeout purchase of 100 shares of ABC under Rule 204, despite the absence of any short position on behalf of the broker or its customer.

Accordingly, Interactive Brokers does not recommend adopting Rule 204 because it would produce pathological results in many cases as a result of the disparate ways that exchange trades versus options exercise and assignment (“EA”) activity are settled. To the extent that CIRO implements such a rule, the CDCC and CDS should allow CDCC exercise and assignment settlements to be included in the CDS CNS process to prevent this type of unintended result.

III. Interactive Brokers proposes allowing broker dealers that have not closed out FTDs to continue short selling so long as they pay per-share fees for FTDs not cured within a reasonable time period.

Subject to the Firm’s recommendation to allow CDCC EA settlements to be included in the CDS CNS process above, the Firm proposes a system of rising monetary fees (perhaps indexed to the borrow fee rate for the stock that was not delivered) for FTDs not cured within a short period (e.g., three business days).

This market-based mechanism would accomplish multiple, competing, goals as follows:

- It would permit the provision of sell-side liquidity to the markets as necessary and likely result in tighter spreads and superior price discovery (relative to a blanket prohibition on short selling), while also financially incentivizing brokers to close FTDs as soon as possible.
- This proposed rule would be much simpler and clearer than tracking Rule 204 closeout obligations, borrows, pre-fail and post-fail credits, and other variables, since brokers would simply keep track of the size of their outstanding FTDs and be charged a market-based fee based on the number of share(s) that had not been delivered, and the length of time that each of those share(s) had not been delivered.



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Interactive Brokers consents to a copy of this comment letter to be made publicly available on the CIRO website.

Regards,

Interactive Brokers Canada Inc.

Jean-François Bernier

Jean-François Bernier
Managing Director

Encls. - Exhibits A, B and C



DIVISION OF
TRADING AND MARKETS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

September 6, 2013

Robert L.D. Colby
Executive Vice President and Chief Legal Officer
Financial Industry Regulatory Authority, Inc.
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Washington DC, 20006

Timothy H. Thompson
Senior Vice President and Chief Regulatory Officer
Chicago Board Options Exchange, Incorporated
C2 Options Exchange, Incorporated
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Re: Request for No-Action Relief with Respect to Multi-day Pre-fail and Post-fail
Credit under Rule 204 of Regulation SHO
TP File No. 13-11

Dear Messrs. Colby and Thompson:

In your letter dated September 6, 2013, Financial Industry Regulatory Authority, Inc. ("FINRA") and Chicago Board Options Exchange, Incorporated ("CBOE") and C2 Options Exchange, Incorporated (together, "Exchanges") jointly request assurances that the staff of the Division of Trading and Markets (the "Division") of the Securities and Exchange Commission ("Commission") will not recommend to the Commission enforcement action if FINRA and the Exchanges enforce compliance with Rule 204 of Regulation SHO consistent with an approach, as further described in your letter, that would generally permit participants of a U.S. registered clearing agency, or U.S. registered broker-dealers to which a participant allocated a fail to deliver position pursuant to Rule 204(d) of Regulation SHO, to claim credit for closing out a fail to deliver position at a registered clearing agency in any equity security prior to the applicable close-out date based on net purchases aggregated over multiple days. A copy of your letter is attached to this response. By including a copy of your correspondence, we avoid having to repeat or summarize the facts and examples you presented. The defined terms in this letter have the same meaning as in your letter, unless otherwise noted.

To meet its close-out obligation under Rule 204, a Participant 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 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).¹ Thus, in establishing the strict close out requirements of Rule 204, the Commission specified that the full quantity of the fail to deliver must be purchased or borrowed on “the applicable close-out date,” which it referenced in the singular, as either T+4 or T+6.² Similarly, a Broker-Dealer may only claim Pre-fail Credit in the limited circumstances where a *bona-fide* purchase or borrow for the entire amount of its fail to deliver³ is effected by that Broker-Dealer on a day that is one of T+1, T+2 or T+3,⁴ and the Broker-Dealer can demonstrate on its books and records that it has a net flat or net long position for that same day.⁵

Notwithstanding the strict close-out requirements of Rule 204, you describe in your letter an approach to claiming Credit for closing out a fail to deliver under Rule 204 based on net purchases aggregated over multiple days (*i.e.*, the Multi-day Approach). You state that the Multi-day Approach would be consistent with the policy goals of Rule 204 to the extent that it encourages more timely resolution of fails to deliver.⁶ You also represent that the Multi-day Approach would be consistent with the requirements of Rule 204 in several ways, including the following:

1. Consistent with Pre-fail Credit under Rule 204(e), the Multi-day Approach would be limited to Broker-Dealers only.⁷
2. The daily net purchase calculation for purposes of Credit would not be applied to any sub-unit of or within a Broker-Dealer (*i.e.*, a specific account or aggregation unit of the Broker-Dealer or of a customer of the Broker-Dealer). Rule 204, in general, applies to Broker-Dealers and does not operate at the individual account or aggregation unit level.⁸

¹ 17 CFR 242.204(a); Rule 204 Adopting Release, 74 FR at 38272. Generally, investors settle their transactions in most exchange-traded securities within three settlement days, 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 the funds for the securities on that third settlement day. The date on which a Broker-Dealer must close out a fail to deliver pursuant to Rule 204 does not affect the security’s settlement date nor extend the timing of delivery obligations for that security. *See* Rule 204 Adopting Release, 74 FR at 38267 n. 16. If a failure to deliver is not closed out as required by Rule 204, it is a violation of Rule 204. *See* Rule 204 Adopting Release, 74 FR at 38266. References throughout this letter to T+ “day” assume a settlement cycle of trade date plus three days. If the financial industry transitioned to a shortened settlement cycle, for example, to trade date plus one or two days, all references to T+ “day” in this letter should be adjusted accordingly. *See, e.g., Cost Benefit Analysis of Shortening the Settlement Cycle*, prepared by the Boston Consulting Group, commissioned by the Depository Trust and Clearing Corporation, Oct. 2012, available at http://www.dtcc.com/downloads/leadership/whitepapers/BCG_2012.pdf?n=59408.

² *See* 17 CFR 242.204(a); Rule 204 Adopting Release, 74 FR at 38272; *see also* Rule 204 Adopting Release, 74 FR at 38271 (referring to “strict close-out requirements”).

³ 17 CFR 242.204(e)(3); Rule 204 Adopting Release, 74 FR at 38276.

⁴ 17 CFR 242.204(e); Rule 204 Adopting Release, 74 FR at 38276.

⁵ 17 CFR 242.204(e)(4); Rule 204 Adopting Release, 74 FR at 38276.

⁶ *See* Rule 204 Adopting Release, 74 FR at 38267, 38276.

⁷ *See* 17 CFR 242.204(e).

⁸ *See, e.g.,* 17 CFR 242.204(a), 242.204(d), 242.204(e). Aggregation units are a specific exception under Rule 200(f) to the firm-wide netting required for order marking under Regulation SHO. *See* 17 CFR 242.200(f).

3. Fails related to sales resulting from options exercises or assignments must be closed out in accordance with Rule 204.⁹
4. Consistent with Rule 204(d), Participants using Allocation with the Multi-day Approach would reasonably Allocate fails using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Allocated Broker-Dealer.¹⁰ A Participant that Allocates a fail to deliver must ensure that the notice is clear as to the quantity of the fail being Allocated and that an Allocation of a fail is being made under Rule 204(d) such that upon Allocation, all obligations under Rule 204(a) and 204(b) rest solely with the Allocated Broker-Dealer.¹¹
5. In the absence of a Rule 204(d) Allocation, the Penalty Box, if triggered, applies to both the Participant and its Correspondents, in each case on a firm-wide basis. In the absence of an Allocation, a Participant may not apply the Penalty Box only to a Correspondent, a customer, or an account or aggregation unit of a Correspondent or customer, to which the Participant determines to pass on the costs of a buy-in.¹²

Based on the foregoing, the Division would not recommend to the Commission enforcement action under Section 19(g)(1) of the Exchange Act¹³ if FINRA and the Exchanges enforce Rule 204 consistent with the Multi-day Approach,¹⁴ or if Broker-Dealers use the Multi-day Approach in connection with their regulatory obligations under Rule 204, on the basis of the

⁹ The Commission has stated that certain transactions that involve options can result in a short sale. *See, e.g.*, Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379, 42379 n.3 (July 21, 2008); Exchange Act Release No. 58611 (Sept. 21, 2008), 73 FR 55556 (Sept. 25, 2008); Exchange Act Release No. 58785 (Oct. 15, 2008), 73 FR 61678, 61681 (Oct. 17, 2008); Exchange Act Release No. 61595 (Feb. 26, 2010), 75 FR 11232, 11263 n.433 (Mar. 10, 2010). For example, the exercise of a put which results in a net short position in the underlying security at the time of exercise would result in a short sale. Thus, short sales occurring as a result of options exercises or assignments are generally subject to the close-out requirements of Rule 204. However, because application of the locate requirement in Rule 203(b)(1) to short sales resulting from options exercises or assignments presently raises certain operational difficulties, under the Multi-day Approach Broker-Dealers would not need to obtain a locate with respect to short sales that result from options exercises or assignments. We also note that short sales pursuant to options exercises and assignments are not subject to Rule 201 of Regulation SHO. *See* Exchange Act Release No. 61595 (Feb. 26, 2010), 75 FR 11232, 11263 n. 433 (Mar. 10, 2010).

¹⁰ *See* Rule 204 Adopting Release, 74 FR at 38273. It would not be reasonable to Allocate fails to deliver in a manner designed to create an advantage for a particular Correspondent, Allocated Broker-Dealer or the Participant, by reducing the fail to deliver amount Attributed to the Correspondent or the fail to deliver amount for which the Allocated Broker-Dealer or Participant is responsible, over other Correspondents or Allocated Broker-Dealers. It would also not be reasonable for a Participant to Allocate fails to deliver without regard to the trade date net trading activities and the net short position of the Allocated Broker-Dealer.

¹¹ In this respect, the Participant must ensure that there is a clear distinction between a notice representing a Rule 204(d) Allocation from an allocation by the Participant of the economic cost of the Participant complying with its own Rule 204(a) obligation (*i.e.*, a buy-in). *See* Rule 204 Adopting Release, 74 FR at 38274 n. 102.

¹² 17 CFR 242.204(b), 242.204(d); *see also* Rule 204 Adopting Release, 74 FR at 38274 n. 102.

¹³ 15 U.S.C. 78s(g).

¹⁴ This no-action position includes the position that the Division would not recommend to the Commission enforcement action if a Broker-Dealer does not take “affirmative action” to close out a fail to deliver position prior to the applicable close-out date by purchasing or borrowing securities and if FINRA and the Exchanges enforce compliance with Rule 204 consistent with this approach. *See* Rule 204 Adopting Release, 74 FR at 38272.

facts, examples and representations set forth in your letter and its Appendix and, in particular, the representations that:

1. The Multi-day Approach would not apply to the requirements to satisfy a close-out obligation on the applicable close-out date (*i.e.*, T+4 or T+6),¹⁵ except to the extent that the amount of the close-out obligation to be met on the applicable close-out date could be reduced by claiming Credit using the Multi-day Approach based on net purchases prior to the applicable close-out date.
2. Credit would only be claimed for days on which the Broker-Dealer can demonstrate on its books and records that it has net purchases for the day, calculated based on the entirety of the Broker-Dealer's *bona fide* trading activity,¹⁶ and in no case would a Broker-Dealer claim Credit for purchases on a day on which its trading activity results in a net sale position, regardless of whether sales executed on that day had a legitimate economic purpose.
3. The Multi-day Approach would be applied in a manner that avoids double-counting net purchases, or purchases for compliance with a close-out date (*i.e.*, T+4 or T+6) requirement. Reliance on the NSCC net delivery obligation under footnote 81 of the Rule 204 Adopting Release¹⁷ would be applied in a manner that avoids double-counting of multi-day activity claimed for Credit.
4. A Participant using Attribution with the Multi-day Approach would reasonably Attribute fails to each Correspondent using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Correspondent. Consistent with Rule 204(d), a Participant using Allocation with the Multi-day Approach would reasonably Allocate fails using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Allocated Broker-Dealer.¹⁸
5. The same reasonableness standard applicable to Attribution under the Multi-day Approach would apply to Allocation under the Multi-day Approach. It would not be reasonable to Attribute fails to Correspondents or to Allocate fails to Allocated Broker-Dealers in a manner designed to create an advantage for a particular Correspondent, Allocated Broker-Dealer or the Participant by reducing the fail to deliver amount Attributed to the Correspondent or the fail to deliver amount for which the Allocated Broker-Dealer or Participant is responsible,

¹⁵ The Multi-day Approach would not be used with respect to fails to deliver for which the applicable close-out date pursuant to Rule 204(a)(2) is no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction.

¹⁶ The same standard for "*bona fide*" used under Rule 204(e)(1) would continue to apply to the aggregate net purchase activity claimed by a Broker-Dealer for this purpose (*i.e.*, the purchase cannot be a sham close-out). For example, 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 transaction, the purchase or borrow will not be "*bona fide*." See 17 CFR 242.204(e)(1); Rule 204 Adopting Release, 74 FR at 38275-38276. See also *infra* note 20.

¹⁷ Rule 204 Adopting Release, 74 FR at 38272 n. 81.

¹⁸ See Rule 204 Adopting Release, 74 FR at 38273. 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. See Rule 204 Adopting Release, 74 FR at 38274 n. 102. The Participant or Allocated Broker-Dealer could pass on the economic cost of complying with its own Rule 204(a) obligation (*i.e.*, a buy-in) based on agreement or understandings with its Correspondents or customers.

over other Correspondents or Allocated Broker-Dealers. It would also not be reasonable to Attribute fails to a Correspondent in a manner designed to claim maximum Credit, without regard to the trade date net trading activities and the net short position of the Correspondent.¹⁹ A Participant using Attribution would not use net purchases of a Correspondent to claim Credit for a fail that is not Attributable to that Correspondent.

6. When calculating the net purchase amount, purchase and sale transactions occurring as a result of options exercises would be recognized on the day exercised, and purchase and sale transactions occurring as a result of options assignments would be recognized on the business day after exercise.²⁰
7. Broker-Dealers using the Multi-day Approach would have supervisory systems in place to ensure that their processes are consistent with the Multi-day Approach as described in your letter and would establish, maintain and enforce written policies and procedures reasonably designed to achieve and surveil for compliance with their Rule 204 close-out obligations using the Multi-day Approach.²¹
8. Broker-Dealers using the Multi-day Approach would also make and keep accurate books and records as required by the federal securities laws, including promptly providing such records to the Commission or an SRO upon request in the manner and form agreed to between the staff of the Commission and the Broker-Dealer or between the staff of the SRO and the Broker-Dealer, as applicable.²²

This position is based on the facts you have presented and the representations you have made. Any different facts or conditions may require a different response. In addition, Division staff, in consultation with the SROs, intends to closely monitor the use of the Multi-day Approach, including its aggregate effect on fails to deliver, by Broker-Dealers relying on this

¹⁹ For example, if a Correspondent was not a net seller on trade date and did not have a net short position, but had net purchases during the applicable multi-day period, the Participant could not use Attribution to claim Credit based on the net purchases of that Correspondent.

²⁰ Where a Broker-Dealer purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions (including options-related transactions) that can be used to re-establish or otherwise extend the fail, and for which the Broker-Dealer is unable to demonstrate a legitimate economic purpose, the Broker-Dealer will not be deemed to have satisfied the close-out requirement. See Rule 204 Adopting Release, 74 FR 38272 n.82. In addition, if a Participant or Allocated Broker-Dealer enters into an arrangement with another person to purchase securities as required by Rule 204, and the Participant or Allocated Broker-Dealer knows or has reason to know that the other person will not deliver securities in settlement of the purchase, then the transaction is a sham close-out, in violation of Rule 204(f). See 17 CFR 242.204(f); Rule 204 Adopting Release, 74 FR at 38278; see also, e.g., *In the Matter of optionsXpress, et al.*, Admin. Proc. File No. 3-14848 (June 7, 2013); *In the Matter of Hazan Capital Management, LLC*, Exchange Act Release No. 60441 (Aug. 5, 2009); *Strengthening Practices for Preventing and Detecting Illegal Options Trading Used to Reset Reg SHO Close-out Obligations*, Office of Compliance Inspections and Examinations National Exam Program Risk Alert, Volume III, Issue 2, Aug. 9, 2013 available at <http://www.sec.gov/about/offices/ocie/options-trading-risk-alert.pdf>.

²¹ See, e.g., FINRA Rule 3130.

²² See, e.g., FINRA Rule 4511. To evidence activity under the Multi-day Approach, books and records would include NSCC notifications of CNS fail amounts each day, or Rule 204(d) Allocation notices from a Participant indicating fails to be closed out each day, both on a security-by-security and aggregate (*i.e.*, firm-wide) basis; contemporaneous records of fails Allocated or Attributed to each Correspondent; contemporaneous records of net purchases claimed for Credit; and a clear ledger reflecting net purchases and sales each day, as well as trade blotters supporting the net purchase or sale calculation.

relief. This position is subject to modification or revocation in the future. The Division expresses no view with respect to any other questions the proposed activities may raise, including, but not limited to, the adequacy of disclosure concerning, and the applicability of other federal and state laws or rules of any SRO to, the proposed activities.

In addition, this no-action position does not address the potential application of the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rules 10b-5 and 10b-21 thereunder.

Sincerely,



Josephine J. Tao
Assistant Director

Attachment

cc: Katrina G. Wilson
Special Counsel



September 6, 2013

By Email and Overnight Mail

Josephine J. Tao, Esq.
Assistant Director
Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Request for No-Action Relief with Respect to Multi-day Pre-fail and Post-fail Credit under Rule 204 of Regulation SHO

Dear Ms. Tao:

Financial Industry Regulatory Authority, Inc. (“FINRA”) and Chicago Board Options Exchange, Incorporated (“CBOE”) and C2 Options Exchange, Incorporated (together, “Exchanges”) respectfully jointly request that the staff of the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (“Commission”) provide assurances that it will not recommend to the Commission enforcement action if FINRA and the Exchanges enforce compliance with Rule 204 of Regulation SHO¹ consistent with an approach, as further described herein, that generally would permit a participant of a registered clearing agency² (“Participant”) or a registered broker-dealer from which a Participant receives trades for clearance and settlement (including introducing and executing brokers) (“Correspondents”) to which a Participant allocates a fail to deliver position pursuant to Rule 204(d) of Regulation SHO (an “Allocated Broker-Dealer”), to claim credit for closing out a fail to deliver position at a

¹ 17 CFR 242.204.

² For purposes of Regulation SHO, the term “participant” has the same meaning as in Section 3(a)(24) of the Securities Exchange Act of 1934 (“Exchange Act”), 15 U.S.C. 78c(a)(24). See Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266, 38268 n. 34 (July 31, 2009) (“Rule 204 Adopting Release”).

registered clearing agency in any equity security (“fail to deliver” or “fail”)³ prior to the applicable close-out date based on net purchases aggregated over multiple days (the “Multi-day Approach”).

I. Background

Under Rule 204 of Regulation SHO (“Rule 204”), Participants must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or must close out a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity.⁴ The Participant must close out a fail to deliver for a short sale transaction by no later than the beginning of regular trading hours⁵ on the settlement day following the settlement date, referred to as T+4.⁶ If a Participant has a fail to deliver that the Participant can demonstrate on its books and records has resulted from a long sale, or 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 must close out the fail to deliver by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, referred to as T+6.⁷

Additionally, to meet its close-out obligation on the applicable close-out date (*i.e.*, T+4 or T+6, as applicable), a Participant must be able to demonstrate on its books and records that it purchased or borrowed shares in the full quantity of its fail to deliver and, therefore, that the Participant has a net flat or net long position on its books and records

³ Fails to deliver occur when a seller fails to deliver securities to the buyer when delivery is due. Rule 204 Adopting Release, 74 FR at 38266 n. 2.

⁴ 17 CFR 242.204(a).

⁵ For purposes of Rule 204, “regular trading hours” has the same meaning as in Rule 600(b)(64) of Regulation NMS. *See* 17 CFR 242.600(b)(64).

⁶ 17 CFR 242.204(a). Generally, investors settle their transactions in most exchange-traded securities within three settlement days, 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 securities at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange the funds for the securities on that third settlement day. The date on which a broker-dealer must close out a fail to deliver pursuant to Rule 204 does not affect the security’s settlement date nor extend the timing of the delivery obligations for that security. *See* Rule 204 Adopting Release, 74 FR at 38267 n. 16. If a fail to deliver is not closed out as required by Rule 204, it is a violation of Rule 204. *See* Rule 204 Adopting Release, 74 FR at 38266.

⁷ 17 CFR 242.204(a)(1) and (a)(3).

on the applicable close-out date.⁸ Thus, in establishing the strict close-out requirements of Rule 204, the Commission specified that the full quantity of the fail to deliver must be purchased or borrowed on “the applicable close-out date,” which it referenced in the singular, as either T+4 or T+6, as applicable.⁹

If a Participant is able to identify the broker-dealers from which a Participant receives trades for clearance and settlement whose trading activities have caused a fail to deliver, the Participant may reasonably allocate a portion of a fail to deliver to a broker-dealer, based on such broker-dealer’s short position under Rule 204(d) (“Allocation” or to “Allocate”).¹⁰ Upon Allocation, the provisions of Rule 204(a) and the “penalty box” provision under Rule 204(b) (the “Penalty Box”) relating to such fail to deliver position apply to the Allocated Broker-Dealer, and not to the Participant.¹¹ Absent such identification and reasonable Allocation, however, the Participant remains subject to the close-out requirement.¹²

Under Rule 204(e), even if a Participant has not closed out a fail to deliver in accordance with Rule 204(a), or has not allocated a fail to deliver to a broker-dealer in accordance with Rule 204(d), a broker-dealer may receive credit for purchases or borrows executed prior to the applicable close-out date if the broker-dealer complies with all four requirements set forth in the “pre-fail credit” provision under Rule 204(e) (“Pre-fail Credit”). A broker-dealer may claim Pre-fail Credit if the broker-dealer purchases or borrows the securities and all of the following requirements are satisfied: (i) the purchase or borrow is *bona fide*; (ii) the purchase or borrow is executed after trade date but by no later than the end of regular trading hours on the settlement date for the transaction (accordingly, the purchase or borrow must be executed on T+1, T+2 or T+3);¹³ (iii) the purchase or borrow is of a quantity of securities sufficient to cover the entire amount of that broker-dealer’s fail to deliver; and (iv) the broker-dealer can demonstrate that it has a net flat or net long position in the security on its books and records on the day of the purchase or borrow.¹⁴ Thus, a broker-dealer may only claim Pre-fail Credit in the limited circumstances where a *bona fide* purchase or borrow for the entire amount of the fail to

⁸ Rule 204 Adopting Release, 74 FR at 38272.

⁹ *Id.*; see also Rule 204 Adopting Release, 74 FR at 38271 (referring to “strict close-out requirements”).

¹⁰ 17 CFR 242.204(d); see also Rule 204 Adopting Release, 74 FR at 38273-38274.

¹¹ *Id.*

¹² *Id.*

¹³ 17 CFR 242.204(e); Rule 204 Adopting Release, 74 FR at 38275-38276.

¹⁴ *Id.*

deliver¹⁵ is effected by that broker-dealer on a single day that is either T+1, T+2 or T+3,¹⁶ and the broker-dealer can demonstrate on its books and records that it has a net flat or net long position on such day.¹⁷

Further, footnote 81 of the Rule 204 Adopting Release provides that, in determining the amount of its close-out obligation, a Participant may rely on its net delivery obligation as reflected in its notification from the National Securities Clearing Corporation (“NSCC”)¹⁸ 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 (*i.e.*, T+4 or T+6).¹⁹

¹⁵ 17 CFR 242.204(e)(3); Rule 204 Adopting Release, 74 FR at 38276.

¹⁶ 17 CFR 242.204(e); Rule 204 Adopting Release, 74 FR at 38276.

¹⁷ 17 CFR 242.204(e)(4); Rule 204 Adopting Release, 74 FR at 38276.

¹⁸ The majority of equity trades in the U.S. are cleared and settled through systems administered by clearing agencies registered with the Commission. 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. The T+3 settlement cycle is the standard settlement cycle for any security traded on a U.S. exchange and cleared through the NSCC’s CNS system. NSCC notifies its members of their securities delivery and payment obligations daily. *See* Rule 204 Adopting Release, 74 FR at 38268 n. 35.

¹⁹ Rule 204 Adopting Release, 74 FR at 38272 n. 81. A Participant may rely on a reduced net delivery obligation as reflected at NSCC to reduce the amount of its close-out obligation prior to claiming Credit using the Multi-day Approach; however, a delivery of shares to CNS may only be used to reduce the close-out obligation if it results in a reduction in the net delivery obligation reflected at NSCC, with the exception of close-out obligations that qualify for an extended close-out period under Rule 204(a)(2). For example, if a delivery of shares to CNS does not reduce the Participant’s net delivery obligation reflected at NSCC, due to offsetting activity, the delivery of shares to CNS would not reduce the amount of the Participant’s close-out obligation and would not satisfy the close-out requirements of Rule 204 because it is not a purchase or borrow. *See* 17 CFR 242.204(a). Further, where a delivery of shares to CNS reduces the Participant’s net delivery obligation reflected at NSCC, the Participant would first apply the reduction to the most recent increase in its fail to deliver reflected at NSCC and then to any increase in its fail to deliver that existed at NSCC on the day preceding that day, and so forth, until the entire amount of the reduction has been applied.

II. Discussion

As discussed with the Division, FINRA and the Exchanges request no-action relief to permit FINRA and the Exchanges to enforce compliance with Rule 204 consistent with, and to permit U.S. registered broker-dealers, including Participants, Allocated Broker-Dealers and Correspondents²⁰ (collectively “Broker-Dealers”), to use the Multi-day Approach, which would allow Broker-Dealers to claim full or partial Pre-fail Credit for closing out, prior to T+4, a fail to deliver that resulted from a short sale transaction based on net purchases aggregated over multiple days from T+1 through T+3 or, where the fail to deliver resulted from a long sale or is attributable to *bona fide* market making activities, would allow Broker-Dealers to claim full or partial credit for closing out a fail to deliver prior to T+6 based on net purchases aggregated over multiple days from T+1 through T+5 (“Post-fail Credit”) (collectively “Credit”).²¹ This request for no-action relief does not address, and the Multi-day Approach would not apply to, the requirements to satisfy a close-out obligation on the applicable close-out date (*i.e.*, T+4 or T+6), except to the extent that the amount of the close-out obligation to be met on the applicable close-out date could be reduced by claiming Credit using the Multi-day Approach based on net purchases prior to the applicable close-out date.²²

FINRA and the Exchanges believe that the Multi-day Approach, as set forth herein, would be consistent with the policy goals of Rule 204 to the extent that it encourages more timely resolution of fails to deliver. The Commission stated in the Rule 204 Adopting Release that it is concerned about reducing fails to deliver.²³ The Commission also stated that the purpose of Rule 204(e) is to encourage broker-dealers to close out fails to deliver prior to the close-out date.²⁴ To ensure that fails to deliver are closed out in a manner that is consistent with these policy goals, a Broker-Dealer using the Multi-day Approach to claim Credit would use the Multi-day Approach in the manner described below. Together with the description below, the examples provided in the Appendix illustrate the intended operation of the Multi-day Approach.

²⁰ See *infra* note 25.

²¹ This request for no-action relief includes a request that the Division provide assurances that it will not recommend to the Commission enforcement action if a Broker-Dealer does not take “affirmative action” to close out a fail to deliver position prior to the applicable close-out date by purchasing or borrowing securities and if FINRA and the Exchanges enforce compliance with Rule 204 consistent with this approach. See Rule 204 Adopting Release, 74 FR at 38272.

²² See *infra* paragraph 4.

²³ Rule 204 Adopting Release, 74 FR at 38267.

²⁴ Rule 204 Adopting Release, 74 FR at 38276.

1. Credit would only be claimed for days on which the Participant or Allocated Broker-Dealer²⁵ can demonstrate on its books and records that it has net purchases for the day²⁶ (*i.e.*, is a “net purchaser” or has “net purchases” or “net purchase activity”).²⁷ The calculation of qualifying net purchases would include the entirety of the *bona fide* trading activity²⁸ of the Participant or Allocated Broker-Dealer, including proprietary trading as well as trading effected by or on behalf of customers, as reflected on the entirety of the Participant’s or Allocated Broker-Dealer’s books and records (*i.e.*, the trading ledger),²⁹ provided that the Allocated

²⁵ Where a Participant does not effect a Rule 204(d) allocation and does not comply with the close-out requirements of Rule 204(a), such that the Participant and its Correspondents would be subject to the Penalty Box, a Correspondent could also use the Multi-day Approach to claim Credit and certify to the Participant that the Correspondent is in compliance with Rule 204(e), such that the Correspondent would not be subject to the Penalty Box. *See* 17 CFR 242.204(b).

²⁶ The calculation of net purchases for the day would include a full day of trading, as reflected on the Participant’s or Allocated Broker-Dealer’s books and records for that day, which would include transactions entered and executed in the time period following the close of regular trading hours (*i.e.*, after hours trading). The calculation of net purchases for the day also could include borrows, provided that such borrows are not already reflected in the Participant’s net delivery obligation at NSCC. *See infra* paragraph 7.

²⁷ In other words, in no case would a Participant or Allocated Broker-Dealer claim Credit for a day on which a Participant or Allocated Broker-Dealer was, according to its books and records, a net seller for the day, regardless of whether sales executed that day had a legitimate economic purpose.

²⁸ The same standard for “*bona fide*” used under Rule 204(e)(1) would continue to apply to the aggregate net purchase activity claimed by a Broker-Dealer for this purpose (*i.e.*, the purchase cannot be a sham close-out). For example, 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 transaction, the purchase or borrow will not be “*bona fide*.” *See* 17 CFR 242.204(e)(1); Rule 204 Adopting Release, 74 FR at 38275-38276. *See also infra* note 40.

²⁹ The net purchase calculation would not be applied to any sub-unit of or within the Participant or Allocated Broker-Dealer (*i.e.*, a specific account or aggregation unit of the firm or of a customer of the firm). Rule 204, in general, applies to Broker-Dealers, and does not operate at the account or aggregation unit level. *See, e.g.*, 17 CFR 242.204(a), 242.204(d) and 242.204(e). Aggregation units are a specific exception under Rule 200(f) to the firm-wide netting required for order marking under Regulation SHO. *See* 17 CFR 242.200(f).

Broker-Dealer's net purchase amount is based only on trading activity cleared and settled through the Participant.³⁰ However, a Participant could claim Credit based on net purchase activity of individual Correspondents,³¹ as described below.

- a. A Participant may use the Multi-day Approach to claim Credit towards a portion of the Participant's fail to deliver attributable to a Correspondent, where the Participant does not Allocate the fail to the Correspondent under Rule 204(d), thereby reducing the amount of the failure to deliver the Participant remains obligated to close out (hereafter referred to as "Attribution" or to "Attribute").³² Credit, up to the amount of the fail to deliver Attributed to that Correspondent, would be based on net purchases of the Correspondent, provided that the net purchase amount is based only on trading activity cleared and settled through the Participant,³³ as

³⁰ Where a Broker-Dealer 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 fail, and for which the Broker-Dealer is unable to demonstrate a legitimate economic purpose, the Broker-Dealer will not be deemed to have satisfied the close-out requirement. *See* Rule 204 Adopting Release, 74 FR 38272 n. 82. This could include sale transactions effected by a Broker-Dealer for clearance and settlement through another Participant.

³¹ Consistent with Pre-fail Credit under Rule 204(e), Credit under the Multi-day Approach would be limited to Broker-Dealers only. *See* 17 CFR 242.204(e). Thus, while qualifying net purchases resulting from the entirety of the *bona fide* trading activity of the Broker-Dealer would include purchases effected by or on behalf of non-broker-dealer customers, Broker-Dealers could not claim Credit based only on net purchases of a single non-broker-dealer customer.

³² The concept of an Attribution for purposes of the Multi-day Approach would be separate and distinct from a Rule 204(d) Allocation. Where a Participant Attributed a fail to deliver to a Correspondent, the obligation to close-out the fail to deliver under Rule 204(a) would remain with the Participant and, if the fail to deliver was not closed out, the Penalty Box under Rule 204(b) would apply to both the Participant and its Correspondents. A Participant could use the Multi-day Approach to claim Credit towards a portion of the Participant's fail to deliver Attributable to a Correspondent. In contrast, where a Participant Allocated a fail to deliver to an Allocated Broker-Dealer, the obligation to close-out the fail to deliver under Rule 204(a) and the Penalty Box under Rule 204(b), if such fail to deliver was not closed out, would apply to the Allocated Broker-Dealer and not to the Participant. The Participant would subtract the Allocated portion of the fail to deliver from the amount of the Participant's close-out obligation and the Participant would not claim Credit based on net purchases by the Allocated Broker-Dealer.

³³ *See supra* note 30.

reflected in the Correspondent's account(s) on the Participant's books and records.³⁴

- b. When using Attribution to claim Credit, the Participant would reasonably Attribute fails to each Correspondent using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Correspondent.³⁵ It would not be reasonable to Attribute fails to deliver to Correspondents in a manner designed to create an advantage for a particular Correspondent, Allocated Broker-Dealer or the Participant, by reducing the fail to deliver amount Attributed to the Correspondent, or the fail to deliver amount for which the Allocated Broker-Dealer or Participant is responsible, over other Correspondents or Allocated Broker-Dealers. It also would not be reasonable to Attribute fails to a Correspondent in a manner designed to claim maximum Credit, without regard to the trade date net trading activity and the net short position of the Correspondent.³⁶ A Participant would not use net purchases of a Correspondent to claim Credit for a fail that is not Attributable to that Correspondent.
- c. Where a Participant Allocates a portion of a fail to deliver to an Allocated Broker-Dealer, the Participant would subtract that portion of the fail to deliver from the amount of the Participant's close-out obligation. The Participant would not claim Credit based on net purchases by the Allocated Broker-Dealer or any of its customers. In this instance, the Allocated Broker-Dealer could claim Credit towards its Allocated fail to deliver using the Multi-day Approach. Consistent with Rule 204(d), Participants using Allocation with the Multi-day Approach would reasonably Allocate fails using a consistently applied methodology designed to resolve fails to deliver, taking into account the trade date net

³⁴ The net purchase calculation would not be applied to any single sub-unit of or within the Correspondent (*i.e.*, a specific account or aggregation unit of the Correspondent or of a customer of the Correspondent). *See supra* note 29.

³⁵ 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. *See* Rule 204 Adopting Release, 74 FR at 38274 n. 102. The Participant or Allocated Broker-Dealer could pass on the economic cost of complying with its Rule 204(a) obligation (*i.e.*, a buy-in) based on agreement or understandings with its Correspondents or customers.

³⁶ For example, if a Correspondent was not a net seller on trade date and did not have a net short position, but had net purchases during the applicable multi-day period, the Participant could not use Attribution to claim Credit based on the net purchases of that Correspondent.

trading activity and net short position of the Allocated Broker-Dealer.³⁷ The same reasonableness standard applicable to Attribution under the Multi-day Approach also applies to Allocation under the Multi-day Approach.

- d. A Participant may claim Credit for any remaining portion of the Participant's fail to deliver (after Allocation and claiming Credit based on Attribution) based on the remaining net purchase activity of the Participant (not including Correspondent net purchase activity claimed for Credit and net purchases by Allocated Broker-Dealers).³⁸
- e. Further, the range of activity covered by "net purchase activity" would include purchases and sales resulting from options exercises and assignments.³⁹ When calculating the net purchase amount, purchase and sale transactions occurring as a result of options exercises would be recognized on the day exercised, and purchase and sale transactions occurring as a result of options assignments would be recognized on the

³⁷ See Rule 204 Adopting Release, 74 FR at 38273. It would not be reasonable for a Participant to Allocate fails to deliver to Allocated Broker-Dealers in a manner designed to create an advantage for a particular Correspondent, Allocated Broker-Dealer or the Participant, by reducing the fail to deliver amount Attributed to a Correspondent, or the fail to deliver amount for which the Allocated Broker-Dealer or Participant is responsible, over other Correspondents or Allocated Broker-Dealers. It would also not be reasonable for a Participant to Allocate fails to deliver without regard to the trade date net trading activity and the net short position of the Allocated Broker-Dealer.

³⁸ The net purchase calculation would not be applied to any single sub-unit of or within the Participant (*i.e.*, a specific account or aggregation unit of the Participant or of a customer of the Participant). See *supra* note 29.

³⁹ The Commission has stated that certain transactions that involve options can result in a short sale. See, *e.g.*, Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379, 42379 n.3 (July 21, 2008); Exchange Act Release No. 58611 (September 21, 2008), 73 FR 55556 (September 25, 2008); Exchange Act Release No. 58785 (October 15, 2008), 73 FR 61678, 61681 (October 17, 2008); Exchange Act Release No. 61595 (February 26, 2010), 75 FR 11232, 11263 n. 433 (March 10, 2010). For example, the exercise of a put which results in a net short position in the underlying security at the time of exercise would result in a short sale. Thus, short sales occurring as a result of options exercises or assignments are generally subject to the close-out requirements of Rule 204. However, short sales pursuant to options exercises and assignments are not subject to Rule 201 of Regulation SHO. See Exchange Act Release No. 61595 (February 26, 2010), 75 FR 11232, 11263 n. 433 (March 10, 2010).

business day after exercise.⁴⁰ Credit for purchases and sales resulting from options exercises and assignments is appropriate because fails resulting from sales as a result of options exercises or assignments are required to be closed out under Rule 204.

2. The Participant or Allocated Broker-Dealer would aggregate net purchases on each relevant trade date prior to the applicable close-out date (*i.e.*, T+4 or T+6).⁴¹ Pre-fail Credit and Post-fail Credit claimed with respect to the same close-out obligation could be combined. That is, net purchases on T+4 and T+5 could be added to net purchases on T+1, T+2 and T+3.
3. In calculating the aggregate multi-day net purchase amount over the applicable multi-day period, the net sale amount on days on which the Broker-Dealer's trading activity results in a net sale position would not be subtracted from the net purchase amount on days on which the Broker-Dealer's trading activity results in a net purchase position.⁴²

⁴⁰ Where a Broker-Dealer purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions (including options-related transactions) that can be used to re-establish or otherwise extend the fail, and for which the Broker-Dealer is unable to demonstrate a legitimate economic purpose, the Broker-Dealer will not be deemed to have satisfied the close-out requirement. *See* Rule 204 Adopting Release, 74 FR 38272 n. 82. In addition, if a Participant or Allocated Broker-Dealer enters into an arrangement with another person to purchase securities as required by Rule 204, and the Participant or Allocated Broker-Dealer knows or has reason to know that the other person will not deliver securities in settlement of the purchase, then the transaction is a sham close-out, in violation of Rule 204(f). *See* 17 CFR 242.204(f); Rule 204 Adopting Release, 74 FR at 38278; *see also, e.g., In the Matter of optionsXpress, et al.*, Admin. Proc. File No. 3-14848 (June 7, 2013); *In the Matter of Hazan Capital Management, LLC*, Exchange Act Release No. 60441 (Aug. 5, 2009); *Strengthening Practices for Preventing and Detecting Illegal Options Trading Used to Reset Reg SHO Close-out Obligations*, Office of Compliance Inspections and Examinations National Exam Program Risk Alert, Volume III, Issue 2, August 9, 2013 available at <http://www.sec.gov/about/offices/ocie/options-trading-risk-alert.pdf>.

⁴¹ The Multi-day Approach would not be used with respect to fails to deliver for which the applicable close-out date pursuant to Rule 204(a)(2) is no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction.

⁴² If a net sale during the applicable multi-day period resulted in a fail to deliver on settlement date, that subsequent fail to deliver would be subject to the close-out requirements of Rule 204.

4. If the aggregate multi-day net purchase amount is less than the full quantity of the fail, it could be used to claim partial Credit, and the Participant or Allocated Broker-Dealer would remain obligated to close out the remaining amount of the fail in accordance with Rule 204(a).
5. Net purchases used to claim Credit, or purchases for compliance with a close-out date (*i.e.*, T+4 or T+6) requirement, with respect to one applicable close-out obligation would not be counted to claim any Credit with respect to a separate and distinct close-out obligation.
6. However, if only a portion of a net purchase is used to claim Credit, or for compliance with a close-out date (*i.e.*, T+4 or T+6) requirement, with respect to one applicable close-out obligation, the remaining portion of the net purchase could be counted to claim Credit with respect to a different close-out obligation.
7. Reliance on the NSCC net delivery obligation under footnote 81 of the Rule 204 Adopting Release would be applied in a manner that avoids double-counting of multi-day activity claimed for Credit. Specifically, to the extent that a reduction in a Participant's fail to deliver at NSCC⁴³ results from purchases or borrows claimed for Credit or for compliance with a prior close-out date (*i.e.*, T+4 or T+6) requirement, the Participant would not apply such reduction to reduce its close-out obligation because the Participant has already received Credit for such reduction or has applied the reduction to the amount of the Participant's prior close out requirement.⁴⁴
8. In the event of an Allocation to an Allocated Broker-Dealer, the Participant would establish a consistent methodology that would similarly apply footnote 81 of the Rule 204 Adopting Release in a manner that avoids double-counting of multi-day activity claimed for Credit. Specifically, the Participant would apply a methodology to reduce the potential for re-applying a reduction in a Participant's fail to deliver at NSCC⁴⁵ that may have resulted from purchases or borrows for compliance with an Allocated Broker-Dealer's close-out requirement and, thus, already have been applied to the amount of the Allocated Broker-Dealer's close out requirement.⁴⁶

⁴³ See *supra* note 19.

⁴⁴ Allocated Broker-Dealers (who do not receive NSCC notifications because they are not Participants) would rely on the Allocation notice received from the Participant prior to the beginning of regular trading hours on the settlement day following settlement date.

⁴⁵ See *supra* note 19.

⁴⁶ For instance, because the Participant may not know whether, when or how the Allocated Broker-Dealer satisfied the Allocated close-out obligation, the Participant could utilize a methodology that assumes that the Allocated Broker-Dealer purchased the full amount of the Allocated fail to deliver on the applicable

9. The Multi-day Approach only would be used to address activity that may occur on trade dates prior to the applicable close-out date (*i.e.*, prior to T+4 or T+6) and in no event would the Multi-day Approach be used to aggregate net purchases on trade dates after the applicable close-out date to satisfy the Penalty Box provision. That is, the Multi-day Approach would not be used where a fail to deliver was not closed out as required, in violation of Rule 204, and for which the Participant and any Correspondents are, or the Allocated Broker-Dealer is, subject to Rule 204(b).⁴⁷ However, a Participant or Allocated Broker-Dealer could use the Multi-day Approach to claim partial Credit based on net purchases prior to the applicable close-out date to reduce the amount it is required to purchase to exit the Penalty Box.

III. Record Keeping and Policies and Procedures for No-Action Relief

In order to ensure that a Broker-Dealer relying on the Multi-day Approach is demonstrably applying it in accordance with the terms described in this letter, any Broker-Dealer using the Multi-day Approach would apply, at a minimum, the following measures:

1. ***Use of Multi-day Approach with Allocation.*** Consistent with Rule 204(d), a Participant that Allocates a fail to deliver must ensure that the notice is clear as to the quantity of the fail being Allocated and that an Allocation of a fail is being made under Rule 204(d) such that upon Allocation, all obligations under Rule 204(a) and 204(b) rest solely with the Allocated Broker-Dealer.⁴⁸ In addition to complying with the requirements of Rule 204(d), a Participant using the Multi-day Approach and Allocating a fail to deliver under Rule 204(d) would have supervisory systems in place to create supporting records, simultaneous with the Allocation process, and maintain such records, specifically identifying (i) the portion(s) of the Participant's fail to deliver it Allocated and the Allocated

close-out date and specifically excludes the assumed purchase amount from reductions in a Participant's fail to deliver at NSCC.

⁴⁷ In the absence of a Rule 204(d) Allocation, the Penalty Box, if triggered, applies to both the Participant and its Correspondents, in each case on a firm-wide basis. In the absence of an Allocation, a Participant may not apply the Penalty Box only to a Correspondent, a customer, or an account or aggregation unit of a Correspondent or customer, to which the Participant determines to pass on the costs of a buy-in. 17 CFR 242.204(b), 242.204(d); *see also* Rule 204 Adopting Release, 74 FR at 38274 n. 102.

⁴⁸ In this respect, the Participant must ensure that there is a clear distinction between a notice representing a Rule 204(d) Allocation from an allocation by the Participant of the economic cost of the Participant complying with its own Rule 204(a) obligation (*i.e.*, a buy-in). *See* Rule 204 Adopting Release, 74 FR at 38274 n. 102.

Broker-Dealer(s) to which it Allocated each portion; and (ii) the trade date activity and net short position that served as a basis for Allocating each portion of the Participant's fail to deliver to such Allocated Broker-Dealer. Additionally, the Participant would be able to reconstruct and produce, in writing, all calculations performed to identify the Allocated Broker-Dealers to which the fail was Allocated, produce a thorough explanation of its Allocation methodology, and demonstrate that it implements such methodology on a consistent basis. Promptly upon request, Participants would provide such records to the staff of the Commission or the staff of a self-regulatory organization ("SRO") in the manner and form agreed upon between the staff of the Commission and the Participant or between the staff of the SRO and the Participant, as applicable. The Participant would make representatives available (in person at the offices of the Commission in Washington, DC or the offices of the SRO at a location designated by the SRO, or by telephone) to explain the Allocation methodology and to respond to inquiries of Commission or SRO staff relating to the Participant's records.

2. ***Use of Multi-day Approach with Attribution.*** A Participant using Attribution would have supervisory systems in place to create supporting records, simultaneous with the Attribution process, and maintain such records, specifically identifying (i) the portion(s) of the fail to deliver Attributed and the Correspondents to which each portion of the fail to deliver was Attributed; (ii) the trade date activity and net short position that served as a basis for Attributing each portion of the fail to deliver to such Correspondents; (iii) the net purchase amount(s) of each Correspondent claimed for Credit; and (iv) the trading activity resulting in the net purchase amount(s) claimed for Credit, as reflected on the books and records of the Participant.⁴⁹ Additionally, the Participant must be able to reconstruct and produce, in writing, all calculations performed to identify the Correspondents to which the fail to deliver was Attributed, produce a thorough explanation of its Attribution methodology, and demonstrate that it implements such methodology on a consistent basis. Promptly upon request, the Participant would provide such records to the staff of the Commission or the staff of an SRO in the manner and form agreed upon between the staff of the Commission and the Participant or between the staff of an SRO and the Participant, as applicable. The Participant would make representatives available (in person at the offices of the Commission in Washington, DC or the offices of the SRO at a location designated by the SRO, or by telephone) to explain the Attribution methodology and to respond to inquiries of Commission or SRO staff relating to the Participant's records.
3. ***Maintenance of examinable policies and procedures.*** A Broker-Dealer using the Multi-day Approach would have supervisory systems in place to ensure that its processes are consistent with the Multi-day Approach, as described herein, and

⁴⁹ Such records would create an audit trail that enables the Commission or SRO to reconstruct the Participant's analytical processes and calculations for selecting the Correspondents to which a fail to deliver was Attributed.

would establish, maintain and enforce written policies and procedures reasonably designed to achieve and surveil for compliance with its Rule 204 close-out obligations using the Multi-day Approach,⁵⁰ including, at a minimum, a description of the methodology that the Broker-Dealer follows with respect to:

- a. the tracking mechanism to avoid double counting net purchases claimed for Credit and purchases for compliance with a close-out date obligation (*i.e.*, T+4 or T+6);
 - b. the application of footnote 81 of the Rule 204 Adopting Release in a manner that avoids double-counting of multi-day activity claimed for Credit;
 - c. the recognition of purchase and sale transactions occurring as a result of options exercises and assignments when calculating net purchases;
 - d. claiming Credit towards a portion of the fail to deliver Attributable to a Correspondent based on net purchases of that Correspondent, including the reasonable Attribution of fails to deliver to Correspondents; and
 - e. reasonable Allocation of fails to deliver to Allocated Broker-Dealers and the tracking mechanism to avoid double counting by the Participant when using the Multi-day Approach in conjunction with Allocation (*i.e.*, no Credit based on net purchases by Allocated Broker-Dealers and accounting for purchases or borrows by Allocated Broker-Dealers when recognizing reductions in the Participant's fail to deliver at NSCC to reduce its close-out obligation).
4. ***Maintenance of examinable books and records.*** A Broker-Dealer using the Multi-day Approach also would make and keep accurate books and records as required by the federal securities laws, including promptly providing such records to the Commission or an SRO upon request.⁵¹

Therefore, based on the foregoing, FINRA and the Exchanges respectfully request that the staff of the Division provide assurances that it would not recommend to the Commission enforcement action if FINRA and the Exchanges enforce Rule 204 consistent with the Multi-day Approach, or if a Broker-Dealer uses the Multi-day

⁵⁰ See, *e.g.*, FINRA Rule 3130.

⁵¹ See, *e.g.*, FINRA Rule 4511. To evidence activity under the Multi-day Approach, books and records would include NSCC notifications of CNS fail amounts each day, or Rule 204(d) Allocation notices from a Participant indicating fails to be closed out each day, both on a security-by-security and aggregate (*i.e.*, firm-wide) basis; contemporaneous records of fails Allocated or Attributed to each Correspondent; contemporaneous records of net purchases claimed for Credit; and a clear ledger reflecting net purchases and sales each day, as well as trade blotters supporting the net purchase or sale calculation.

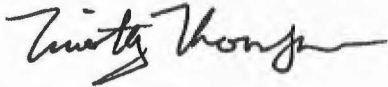
Josephine J. Tao, Esq.
September 6, 2013
Page 15 of 19

Approach in connection with its regulatory obligations under Rule 204, as set forth in this letter.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert Colby", with a long horizontal flourish extending to the right.

Robert L.D. Colby
Executive Vice President and Chief Legal Officer
Financial Industry Regulatory Authority, Inc.

A handwritten signature in black ink, appearing to read "Timothy Thompson", with a long horizontal flourish extending to the right.

Timothy H. Thompson
Senior Vice President and Chief Regulatory Officer
Chicago Board Options Exchange, Incorporated
C2 Options Exchange, Incorporated

Attachment

cc: Katrina G. Wilson, Special Counsel, Division of Trading and Markets

Appendix

The following examples illustrate the Multi-day Approach as described above. Paragraph numbers/letters correspond to the paragraphs describing the Multi-day Approach under Section II., Discussion, above. All examples assume no trading activity other than the activity described.

Example 1 (Paragraph 1.): The Participant (given a T+4 close-out obligation of 1,000 shares) has net purchases of 400 shares on T+1 in its proprietary account, but customers clearing through the Participant have sold a total of 1,000 shares on T+1, resulting in the Participant being a net seller of 600 shares on the entirety of its books and records. Therefore, absent Attribution, the Participant could not claim Credit for activity on T+1.

Example 2 (Paragraph 1.): (Given a T+4 close-out obligation of 1,000 shares) on T+1 the Participant's market making unit has net purchases of 300 shares, but its statistical arbitrage unit has net sales of 1,000 shares, its options unit has net purchases of 100 shares and its derivatives unit has net purchases of 100 shares. In addition, customers clearing through the Participant have purchased a total of 100 shares on T+1. The Participant has net sales of 400 shares on the entirety of its books and records on T+1, and, therefore, is not a net purchaser and, absent Attribution, could not claim Credit for any purchase activity on T+1.

Example 3 (Paragraph 1.a.): (Given a T+4 close-out obligation of 1,000 shares) after determining that 600 shares of the fail is Attributable to Correspondent A, a Participant could aggregate Correspondent A's net purchases of 300 shares on T+1, Correspondent A's net purchases of 200 shares on T+2, and Correspondent A's net purchases of 100 shares on T+3 and count those combined net purchases as Pre-fail Credit.

Example 4 (Paragraph 1.a.): (Given a T+4 close-out obligation of 1,000 shares) after determining that 600 shares of the fail is Attributable to Correspondent B, if Correspondent B had net purchases of 300 shares on T+1, net purchases of 300 shares on T+2, and net purchases of 300 shares on T+3, the Participant could only claim a total of 600 shares of Correspondent B's net purchases as Pre-fail Credit.

Example 5 (Paragraph 1.c.): (Given a T+4 close-out obligation of 1,000 shares) after allocating 600 shares of the fail to deliver to Allocated Broker-Dealer C, the Participant would subtract 600 shares from the Participant's close-out obligation, bringing the close-out obligation to 400 shares and would not claim Credit based on Allocated Broker-Dealer C's net purchases of 300 shares on T+1, Allocated Broker-Dealer C's net purchases of 200 shares on T+2, and Allocated Broker-Dealer C's net purchases of 100 shares on T+3. Allocated Broker-Dealer C could aggregate its net purchases of 300 shares on T+1, its net purchases of 200 shares on T+2, and its net purchases of 100 shares on T+3 and count those combined net purchases as Pre-fail Credit.

Example 6 (Paragraph 1.d.): (Given a T+4 close-out obligation of 1,000 shares), the Participant Attributes 600 shares of the fail to deliver to Correspondent A that has net purchases of 300 shares on T+1, net purchases of 100 shares on T+2, and net purchases

of 100 shares on T+3. The Participant Allocates 100 shares of the fail to deliver to Allocated Broker-Dealer B that has net purchases of 300 shares on T+2. The Participant has net purchases, including the Participant's proprietary accounts and any Correspondents not being Allocated or Attributed a portion of the fail to deliver, of 200 shares on T+3. After claiming Credit for Correspondent A's net purchases of 500 shares using Attribution and Allocating 100 shares to Allocated Broker-Dealer B, the Participant's remaining close-out obligation is 400 shares. The Participant could claim Credit based on the Participant's net purchases of 200 shares on T+3. The Participant would not claim any Credit based on the Allocated Broker-Dealer's net purchases of 300 shares on T+2.

Example 7 (Paragraph 1.f): (Given a T+4 close-out obligation of 1,000 shares) if a Participant has net purchases of 500 shares resulting from stock transactions and exercises a long call for 300 shares on T+1, and on T+2 receives an assignment on a put for 200 shares, the Participant could claim Credit for net purchases of 800 shares on T+1 and could claim Credit for net purchases of 200 shares on T+2 as a result of the 200 share put assignment.

Example 8 (Paragraph 1.f): (Given a T+4 close-out obligation of 1,000 shares) if a Participant has net purchases of 500 shares resulting from stock transactions and exercises a put for 300 shares on T+1, and on T+2 receives an assignment on a call for 200 shares, the Participant could claim Credit for net purchases of 200 shares on T+1 and could not claim Credit on T+2 because it had net sales of 200 shares on T+2 as a result of the call assignment.

Example 9 (Paragraph 2.): (Given a T+4 close-out obligation of 1,000 shares) a Participant could aggregate net purchases of 300 shares on T+1, net purchases of 300 shares on T+2, and net purchases of 400 shares on T+3 and count those combined net purchases as Pre-fail Credit.

Example 10 (Paragraph 2.): (Given a T+6 close-out obligation of 1,000 shares) the Participant could aggregate net purchases of 300 shares on T+1, net purchases of 300 shares on T+2, net purchases of 200 shares on T+3, net purchases of 100 shares on T+4, and net purchases of 100 shares on T+5 and count those combined net purchases as Credit for the close-out obligation.

Example 11 (Paragraph 3.): The Participant (given a T+4 close-out obligation of 1,000 shares) could aggregate net purchases of 500 shares on T+1 and net purchases of 500 shares on T+3, and would not subtract net sales of 200 shares on T+2. Thus, the Participant would receive Pre-fail Credit for 1,000 shares.

Example 12 (Paragraph 4.): The Participant (given a T+6 close-out obligation of 1,000 shares) could aggregate net purchases of 300 shares on T+1, net purchases of 300 shares on T+2, net purchases of 100 shares on T+3, and net purchases of 200 shares on T+4, and would not subtract net sales of 100 shares on T+5, resulting in a close-out obligation of 100 shares on the morning of T+6.

Example 13 (Paragraph 5.): If the Participant (given a T+4 close-out obligation of 1,000 shares) had net purchases of 400 shares on T+1 (Monday) and net purchases of 600 shares on T+3 (Wednesday), the Participant could claim the 400 shares from T+1

(Monday) and the 600 shares from T+3 (Wednesday) towards the close-out obligation due on T+4 (Thursday). If the Participant had another close-out obligation due the following Monday (as a result of a net sale on the prior Tuesday), the Participant could not claim Credit for the 600 share net purchase on Wednesday towards that different close-out obligation.

Example 14 (Paragraph 6.): If the Participant (given a T+4 close-out obligation of 1,000 shares) had net purchases of 400 shares on T+1 (Monday) and net purchases of 700 shares on T+3 (Wednesday), the Participant could claim Credit for the 400 shares from T+1 (Monday) and for 600 of the shares from T+3 (Wednesday) towards the close-out obligation due on T+4 (Thursday). If the Participant had another close-out obligation due the following Monday (as a result of a net sale on the prior Tuesday), the Participant could claim Credit for the remaining 100 shares of the net purchase on Wednesday towards that different close-out obligation.

Example 15 (Paragraph 6.): If the Participant (given a T+6 close-out obligation of 1,000 shares) executes a close-out purchase of 1,000 shares prior to the beginning of regular trading hours on T+6 (Monday) and, later that day, the Participant purchases an additional 1,500 shares so that the Participant has net purchases of 2,500 shares at the end of the day Monday, the Participant could not use the full 2,500 share net purchase from Monday as Credit for a separate T+6 close-out obligation of 3,000 shares due on Wednesday. The Participant could, however, use 1,500 shares of the net purchase from Monday as Credit for the separate T+6 close-out obligation due on Wednesday.

Example 16 (Paragraph 7.): If the Participant (given a T+6 close-out obligation of 1,000 shares) had net purchases of 400 shares on T+1, assuming no other activity, the Participant's net delivery obligation at NSCC prior to the beginning of regular trading hours on T+6 would reflect a reduced fail to deliver of 600 shares (the original close-out obligation of 1,000 shares would be reduced as a result of the T+1 net purchases). If the Participant referenced the reduced fail of 600 shares and then claimed Pre-fail Credit for the same net purchases of 400 shares on T+1 to reduce its close-out obligation to 200 shares, the Participant would inappropriately double count the net purchases of 400 shares.

Example 17 (Paragraph 8.): (Given a T+4 close-out obligation of 1,000 shares), the Participant Allocates 700 shares of the fail to deliver to Allocated Broker-Dealer B that has net purchases of 200 shares on T+1, leaving the Participant with a remaining close-out obligation of 300 shares. The Participant would not claim any Credit based on the Allocated Broker-Dealer's net purchases of 200 shares on T+1. The Participant would also assume that the Allocated Broker-Dealer purchased 700 shares on T+4 and would not recognize a reduction of 700 shares in the Participant's fail to deliver at NSCC on the third consecutive settlement day following T+4 to reduce a close-out obligation for a subsequent fail.

Example 18 (Paragraph 9.): The Participant (given a T+4 close-out obligation of 1,000 shares) could aggregate net purchases of 100 shares on T+1, 300 shares on T+2 and 200 shares on T+3. If the Participant did not close out the remaining 400 shares on the morning of T+4, as required by Rule 204(a), for whatever reason, the Penalty Box would

Josephine J. Tao, Esq.
September 6, 2013
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apply to the Participant and its Correspondents until the Participant purchased the full amount of the remaining 400 shares of the fail and that purchase cleared and settled.



DIVISION OF
TRADING AND MARKETS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

October 27, 2014

Beth A. Stekler, Partner
Wilmer Cutler Pickering Hale and Dorr LLP
1875 Pennsylvania Avenue, NW
Washington, D.C. 20006

Re: Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Certain
Subsequent Trading Activity on a Close-Out Date
TP File No. 15-03

Dear Ms. Stekler:

In your letter dated October 27, 2014, Wilmer Cutler Pickering Hale and Dorr LLP on behalf of Goldman Sachs Execution & Clearing, L.P. (“GSEC” or the “firm”) requests assurances that the staff of the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (“Commission”) will not recommend to the Commission enforcement action under Rule 204 of Regulation SHO (“Rule 204”) of the Securities Exchange Act of 1934 (the “Exchange Act”) if GSEC establishes, maintains and enforces certain written policies and procedures, described in detail in your letter, that are reasonably designed to address certain subsequent activity on the date that GSEC effects a close-out pursuant to Rule 204(a). A copy of your letter is attached to this response in order to avoid repeating or summarizing the facts and details you presented. The defined terms in this letter have the same meaning as in your letter, unless otherwise noted.

To meet its close-out obligation under Rule 204, a Participant 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 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).¹ The quantity of a Participant’s close-out requirement under Rule 204 is based on a Participant’s fail to deliver position at a registered clearing agency.² 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

¹ 17 CFR 242.204(a); Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266, 38272 (July 31, 2009) (“Rule 204 Adopting Release”). Generally, investors settle their transactions in most exchange-traded securities within three settlement days, known as T+3. T+3 means that, when a trade occurs, the participants in 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 the funds for the securities on that third settlement day. References throughout this letter to T+ “day” assume a settlement cycle of trade date plus three days. If the financial industry transitioned to a shortened settlement cycle, for example, to trade date plus one or two days, all references to T+ “day” in this letter should be reinterpreted accordingly. *See, e.g., Cost Benefit Analysis of Shortening the Settlement Cycle*, prepared by the Boston Consulting Group, commissioned by the Depository Trust and Clearing Corporation, Oct. 2012, available at http://www.dtcc.com/downloads/leadership/whitepapers/BCG_2012.pdf?n=59408.

² *See id.* The National Securities Clearing Corporation (“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 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. *See* Rule 204 Adopting Release, 74 FR at 38268 n.35.

received prior to the beginning of regular trading hours on the applicable close-out date.³ CNS delivery obligations are net delivery obligations, covering the totality of the activity cleared by the Participant through CNS. As a result, the Rule 204 close-out requirement is based on a net fail to deliver position and the net flat or net long requirement is a net requirement, applying to the net trading activity on the Participant's books and records on the applicable close-out date, including all proprietary activity of the Participant, as well as activity by customers and clients.

The Commission further specified that 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.⁴ Sales with a legitimate economic purpose are not an exception to the requirement to purchase or borrow the full quantity of the fail to deliver and, therefore, have a net flat or net long position on the applicable close-out date.⁵ Thus, if a Participant cannot demonstrate that it has a net flat or net long position on its books and records on the applicable close-out date, the Participant has not met its close-out obligation, regardless of whether sales on that day had a legitimate economic purpose.

You indicate in your letter that the requirement to demonstrate that the Participant has a net flat or net long position on its books and records on the applicable close-out date creates significant operational and practical problems for GSEC because clients may effect transactions at or very near market close and because a substantial majority of the equity share volume that GSEC clears and settles for its custodial clients is executed "away" from the Firm (*i.e.*, through another broker-dealer) and GSEC is not informed of certain of those "away" transactions until well after 4:00 p.m. Eastern time.

Notwithstanding the strict close-out requirements of Rule 204,⁶ you describe in your letter a proposed approach to addressing the Commission's policy goal of reducing fails to deliver,⁷ and, specifically, the concern that subsequent activity on the date of a Rule 204 close out may serve to re-establish a short position and thus potentially extend a CNS fail to deliver. Specifically, you represent that GSEC will establish, maintain and enforce certain written policies and procedures, described in detail in your letter, that are reasonably designed to address certain subsequent trading activity⁸ on a Rule 204 close-out date (the "NFNL Approach").

As described in further detail in your letter, under the NFNL Approach, GSEC would reasonably allocate close-out responsibility to Market Maker Broker-Dealers pursuant to Rule 204(d). Further, GSEC would identify Clients that caused or contributed to the firm's net fail to deliver to CNS and determine the number of shares attributable to each such Client. To the extent that GSEC purchases shares to satisfy its Rule 204 obligation in a security and passes the purchased shares and the costs thereof through to Clients, GSEC would require such Covered Clients to end the day on the close-out date as a "net purchaser"⁹ of a Specified Quantity, that is, the number of shares at least equal to the number of shares passed to the Covered Client on that day.

³ See Rule 204 Adopting Release, 74 FR at 38272 n.81.

⁴ See *id.* at 38272 n.82.

⁵ See *id.* ("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, 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.").

⁶ See FINRA Letter of Acceptance Waiver and Consent 20060060880-01, signed March 26, 2014.

⁷ See Rule 204 Adopting Release, 74 FR at 38267, 38276.

⁸ Such subsequent trading activity includes purchase and sale transactions occurring as a result of options exercises and assignments. See *infra* note 9.

⁹ Consistent with the conditions of the Multi-Day Close-Out Credit Letter, when GSEC determines whether a Covered Client ended the day on a close-out date as a "net purchaser" of a number of shares of the relevant security at least equal to the Specified Quantity, GSEC will recognize purchase and sale transactions occurring as a result of options exercises

If a Covered Client did not, on the applicable Rule 204 close-out date, end the day as a “net purchaser” of a number of shares of the relevant security at least equal to the corresponding Specified Quantity, GSEC would, no later than the beginning of regular trading hours on the following trading day, buy-in the Covered Client for the amount of shares that, when added to the Covered Client’s net trading activity on the applicable close-out date, would have been required to make the Covered Client a “net purchaser” of the Specified Quantity on the close-out date, regardless of the Covered Client’s position or activity on the trading day following the applicable close-out date.

GSEC will also establish, maintain and enforce written policies and procedures that are reasonably designed to monitor the trading activity of Covered Clients and detect whether a Covered Client has engaged in a pattern of trading activity that could be used to re-establish the Covered Client’s short position and thus potentially extend GSEC’s fail to deliver to CNS.

Based on the foregoing and the facts and representations set forth in your letter, the Division would not recommend to the Commission enforcement action under Rule 204 regarding subsequent activity on the date that GSEC effects a close-out if GSEC complies with Rule 204 consistent with the NFNL Approach¹⁰ and, in particular, the representations that:

1. GSEC determines the number of shares to allocate to Market Maker Broker-Dealers using a reasonably designed and consistently applied method, taking into account the trade date net trading activity and the net short position of each Market Maker Broker-Dealer. GSEC does not allocate fails to deliver in a manner designed to create an unfair advantage for a particular client, allocated broker-dealer, or GSEC.¹¹
2. GSEC will ensure that its allocation notifications to Market Maker Broker-Dealers (and to any other broker-dealer clients to which GSEC may allocate close-out responsibility pursuant to Rule 204(d)) are clear as to the number of shares being allocated and that an allocation of legal responsibility is being made under Rule 204(d). In this regard, there will be a clear distinction between a notification representing a Rule 204(d)

on the day exercised and purchase and sale transactions occurring as a result of options assignments on the business day after assignment.

¹⁰ GSEC also represents that, as part of the New Approach, it will establish, maintain and enforce certain written policies and procedures that are reasonably designed to address certain subsequent trading activity on the date of a Rule 203(b)(3) close-out. *See* 17 CFR 242.203(b)(3). Such written policies and procedures will be consistent with the firm’s written policies and procedures to address certain subsequent trading activity on a Rule 204 close-out date, with the exception of differences necessary to account for the requirements of Rule 203(b)(3) regarding fail to deliver positions in a threshold security that have persisted for thirteen consecutive settlement days. Accordingly, the Division would not recommend to the Commission enforcement action pursuant to Rule 203(b)(3) regarding subsequent trading activity on the date that GSEC effects a close-out if GSEC establishes, maintains and enforces the New Approach in this manner.

¹¹ GSEC represents that for purposes of GSEC’s Rule 204 methodology in general and allocation of close-out responsibility pursuant to Rule 204(d) in particular, only the market making business line (*i.e.*, all activity and positions in such client’s market making accounts) is deemed to be the “market maker broker-dealer;” the non-market making business line of such client (*i.e.*, all activity and positions in such client’s non-market making accounts) does not receive market maker treatment, and that non-market making business line is treated as a separate broker-dealer client for purposes of GSEC’s Rule 204 methodology. Under Rule 204(d), when a Participant reasonably allocates a fail to deliver position to another registered broker-dealer for which it clears trades or from which it receives trades for settlement, all obligations under Rule 204(a) and 204(b) rest solely with the allocated broker-dealer, and not with the Participant. *See* 17 CFR 242.204(d); *see also* Rule 204 Adopting Release, 74 FR at 38273-38274. A broker-dealer that receives a fail allocation from a Participant, such as GSEC, is responsible for determining whether the fail is attributable to bona fide market making activity and may be closed out on a T+6 basis pursuant to Rule 204(a)(3). The broker-dealer cannot rely solely on its labelling of an account as a market making account, on the designation of any trader or unit as a “market maker,” or in reliance on an exchange registration or eligibility for an exchange designation as a market maker, whether for purposes of the NFNL Approach or otherwise, but must consider whether the short sales in the market making account or within the market maker unit also qualify as bona fide market making for purposes of Regulation SHO. *See* Exchange Act Release No. 58775 (Oct. 14, 2008), 73 FR 61690, 61698 (Oct. 17, 2008); Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48015 (Aug. 6, 2004).

allocation and a notification in which GSEC attributes to a client the economic cost of GSEC complying with its own Rule 204(a) obligation (*i.e.*, a buy-in) and thereby passes shares (and the cost thereof) to the client.

3. GSEC will identify the Clients that caused or contributed to the firm's net fail to deliver to CNS and determine the number of shares attributable to each such Client using a reasonably designed and consistently applied method, taking into account the trade date net trading activity and the net short position of each Client. GSEC will not attribute fails to deliver in a manner designed to create an unfair advantage for a particular Client, allocated broker-dealer or GSEC.
4. GSEC understands that the identification of and notification to Clients¹² that caused or contributed to GSEC's net fail to deliver to CNS as described in your letter is not an allocation under Rule 204(d) and that, as such, GSEC does not transfer legal responsibility for complying with Rule 204 to such Clients.
5. If GSEC detects that a Covered Client has engaged in a pattern of trading activity that could be used to re-establish the Covered Client's short position and thus potentially extend GSEC's fail to deliver to CNS, GSEC will escalate issues relating to such conduct to GSEC's Compliance Department, which, in conjunction with other appropriate GSEC personnel, will determine whether any other action should be taken in light of all relevant facts and circumstances.¹³
6. To the extent that GSEC commits its own capital to purchase the shares (rather than assigning the economic cost to Clients), GSEC represents that its firm accounts will end the day on the close-out date as a "net purchaser" of a number of shares of the relevant security at least equal to the amount of the fail to deliver position closed-out by the firm accounts.
7. GSEC recognizes that, to satisfy its Rule 204 close-out obligation, in whole or in part, by borrowing shares, GSEC must borrow¹⁴ shares by no later than the beginning of regular trading hours on the morning of a Rule 204 close-out date. To the extent that all or a portion of GSEC's Rule 204 obligation has not been satisfied (by borrowing or otherwise) by the beginning of regular trading hours on the morning of the Rule 204 close-out date, GSEC will purchase shares to satisfy its Rule 204 close-out obligation and will apply the NFNL Approach to such purchases.
8. Securities in which GSEC has a Rule 204 close-out obligation will not appear on the ETB list for the applicable close-out date and, accordingly, GSEC will not utilize the ETB list to grant locates for such securities on the applicable close-out date.
9. GSEC will make and keep accurate books and records as required by the federal securities laws, including books and records sufficient to demonstrate that GSEC is following the terms of the NFNL Approach as described in your letter, and will promptly provide such records to the Commission upon request.

This position is based solely on the representations in your October 27, 2014 letter and the representations and facts you have presented to the Division staff and is strictly limited to the application of the NFNL Approach under Rule 204 as described above and in your October 27, 2014 letter. Any different facts or representations

¹² GSEC has sole responsibility for the provision of these notices and the other notices described in its letter.

¹³ A broker-dealer has potential aiding and abetting liability under Rule 10b-21. 17 CFR 240.10b-21. *See also* Exchange Act Release No. 58774 (Oct. 14, 2008), 73 FR 61666, 61673 (Oct. 17, 2008); *In the Matter of Gomul Colak and Milen K. Costov*, Exchange Act Release No. 71461 (Jan. 31, 2014), available at <http://www.sec.gov/litigation/admin/2014/33-9522.pdf>; *SEC v. Scott I. Kupersmith and Frederick C. Chelly*, Civil Action No. 11-CV-6277 (KSH) (D.N.J.), available at <http://www.sec.gov/litigation/complaints/2011/comp22142.pdf>.

¹⁴ To satisfy a close-out obligation by borrowing shares, the Participant must enter into a legally binding agreement with the lender to borrow/loan shares (in accordance with the terms of a securities lending agreement) by no later than the beginning of regular trading hours on the Rule 204 close-out date. Unlike Rule 203(b)(1) and Rule 204(b), which permit a borrow or "bona-fide arrangement to borrow," Rule 204(a) permits only a borrow and does not permit a "bona-fide arrangement to borrow the security" in satisfaction of the Rule's close-out requirement. *See* 17 CFR 242.204(a); 17 CFR 242.203(b)(1)(i); 17 CFR 242.204(b).

may require a different response. In the event that any material change occurs in the facts or representations in your letter, the use of the NFNL Approach shall be discontinued, pending presentation of the facts for our consideration. In addition, Division staff intends to closely monitor the use of the NFNL Approach, including its aggregate effect on fails to deliver. This position is subject to modification or revocation in the future. The Division expresses no view with respect to any other questions the proposed activities may raise, including, but not limited to, the adequacy of disclosure concerning, and the applicability of other federal and state laws or rules of any Self-Regulatory Organization to, the proposed activities. In addition, this no-action position does not address the potential application of the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rules 10b-5 and 10b-21 thereunder.

Sincerely,



Josephine J. Tao
Assistant Director

Attachment

cc: Valerie Dahiya
Special Counsel

Beth A. Stekler

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October 27, 2014

Josephine J. Tao
Assistant Director
Division of Trading and Markets
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Certain
Subsequent Trading Activity on a Close-Out Date

Dear Ms. Tao:

Wilmer Cutler Pickering Hale and Dorr LLP, on behalf of Goldman Sachs Execution & Clearing, L.P. (“GSEC” or the “firm”),¹ respectfully requests that the staff of the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (“Commission” or “SEC”) provide assurances that it will not recommend to the Commission enforcement action under Rule 204 of Regulation SHO (“Rule 204”) of the Securities Exchange Act of 1934 (the “Exchange Act”),² if GSEC establishes, maintains and enforces certain written policies and procedures, described in detail herein, that are reasonably designed to address certain subsequent activity on the date that GSEC effects a close-out pursuant to Rule 204(a). GSEC makes this request in light of certain operational and practical difficulties that GSEC faces in attempting to comply with the “net flat or net long position” language in the Rule 204 Adopting Release.³

¹ GSEC acts as a clearing firm and offers agency-only electronic brokerage services. GSEC does not trade on a principal basis, although in connection with providing execution and clearing services, GSEC may engage in transactions in certain types of firm accounts, including error accounts, buy-in accounts, and the like.

² See 17 CFR 242.204; Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 at 38272 (July 31, 2009) (the “Rule 204 Adopting Release”).

³ *Id.*

Ms. Josephine J. Tao
October 27, 2014
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Regulation SHO Close-Out Requirements Under Rule 204

Under Rule 204, a participant of a registered clearing agency⁴ (“Participant”) must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or must close out a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity.⁵ The Participant must close out a fail to deliver for a short sale transaction by no later than the beginning of regular trading hours⁶ on the settlement day following the settlement date, referred to as T+4.⁷ If a Participant has a fail to deliver that the Participant can demonstrate on its books and records has resulted from a long sale, or 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 must close out the fail to deliver position by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, referred to as T+6.⁸

In its Rule 204 Adopting Release, the Commission stated that, to meet the 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.*, T+4 or T+6, as applicable).⁹ Footnote 82 of the Rule 204 Adopting Release provides that, 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.¹⁰

⁴ For purposes of Regulation SHO, the term “participant” has the same meaning as in Section 3(a)(24) of the Exchange Act, 15 U.S.C. 78c(a)(24). See Rule 204 Adopting Release, 74 FR at 38268 n. 34.

⁵ 17 CFR 242.204(a).

⁶ For purposes of Rule 204, “regular trading hours” has the same meaning as in Rule 600(b)(64) of Regulation NMS. See 17 CFR 242.600(b)(64).

⁷ 17 CFR 242.204(a). Generally, investors settle their transactions in most exchange-traded securities within three settlement days, known as T+3.

⁸ 17 CFR 242.204(a)(1) and (a)(3).

⁹ See Rule 204 Adopting Release, 74 FR at 38272.

¹⁰ See *id.* at 38272 n.82.

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Under Rule 204(d), if a Participant is able to identify the broker-dealers from which the Participant receives trades for clearance and settlement whose trading activities have caused or contributed to a fail to deliver, the Participant may reasonably allocate a portion of its fail to deliver position to a broker-dealer, based on such broker-dealer's short position.¹¹ Upon allocation, the requirements of Rule 204(a), as described above, as well as the "penalty box" provision under Rule 204(b)¹² relating to such fail to deliver position, apply to the broker-dealer to whom close-out responsibility was allocated, and not to the Participant.¹³

Operational and Practical Difficulties

A requirement or expectation that a Participant on an aggregate net basis, including all client activity cleared by the Participant, end the day on a Rule 204 close-out date as a "net purchaser" of a number of shares at least equal to the Participant's Rule 204 close-out obligation would create significant operational and practical problems for GSEC for a variety of reasons. For example, clients may effect transactions at or very near market close. In addition, a substantial majority of the equity share volume that GSEC clears and settles for its custodial clients is executed "away" from the Firm (*i.e.*, through another broker-dealer). GSEC frequently is not informed of certain of those "away" transactions until well after 4:00 p.m. Eastern time.

As a result of these factors, GSEC has been unable to determine before the end of regular trading hours on a Rule 204 close-out date whether GSEC on a net basis, including all client activity cleared by the firm, will be a net purchaser of a number of shares of a security at least equal to GSEC's Rule 204 close-out obligation in that security.

Proposed Approach To Close-out Date Activity

GSEC takes its obligation to comply with Rule 204 seriously and respects the Commission's concern regarding fails to deliver and the important role that Rule 204 plays in efforts by the Commission to address fails. In an effort to address some of the operational and practical difficulties discussed above, GSEC has made changes to its Rule 204 methodology to reasonably allocate close-out responsibility to market maker broker-dealers¹⁴ for which GSEC

¹¹ 17 CFR 242.204(d); *see also* Rule 204 Adopting Release, 74 FR at 38273-38274.

¹² 17 CFR 242.204(b).

¹³ *See id.* at n.11.

¹⁴ Because various regulatory requirements, including Rule 204, provide for different treatment with respect to bona fide market making activity, GSEC requires broker-dealer clients that engage in both market making activity and non-market making activity to maintain separate accounts for those distinct lines of business. Only transactions/positions in such a client's designated market making accounts are afforded market maker treatment. In particular, for purposes of GSEC's Rule 204 methodology in general and

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clears trades or from which GSEC receives trades for settlement (“Market Maker Broker-Dealers”),¹⁵ pursuant to Rule 204(d).¹⁶

Moreover, GSEC understands that the Division staff has concerns regarding subsequent activity on the date of a Rule 204 close out that may serve to re-establish a client’s short position and thus potentially extend GSEC’s fail to deliver to the Continuous Net Settlement System (“CNS”) in the security. To address such concerns, and in light of the operational difficulties noted above, GSEC represents that it will establish, maintain and enforce certain written policies and procedures, described in detail below, that are reasonably designed to address certain subsequent trading activity on a Rule 204 close-out date (the “New Approach”) and respectfully requests that the staff of the Division provide assurances that it will not recommend enforcement action against the firm under Rule 204 regarding subsequent trading activity on the date that GSEC effects a close-out if GSEC establishes, maintains and enforces the New Approach.¹⁷

allocation of close-out responsibility pursuant to Rule 204(d) in particular, only the market making business line (*i.e.*, all activity and positions in such client’s market making accounts) is deemed to be the “market maker broker-dealer.” The non-market making business line of such client (*i.e.*, all activity and positions in such client’s non-market making accounts) does not receive market maker treatment, and that non-market making business line is treated as a separate broker-dealer client for purposes of GSEC’s Rule 204 methodology.

¹⁵ See Rule 204 Adopting Release, 74 FR at 38273. GSEC determines the number of shares to allocate to Market Maker Broker-Dealers using a reasonably designed and consistently applied method, taking into account the trade date net trading activity and the net short position of each Market Maker Broker-Dealer. GSEC does not allocate fails to deliver in a manner designed to create an unfair advantage for a particular client, allocated broker-dealer or GSEC.

¹⁶ See 17 CFR 242.204(d); Rule 204 Adopting Release, 74 FR at 38273-74. When GSEC allocates responsibility to a Market Maker Broker-Dealer under Rule 204(d), all obligations under Rule 204(a) and 204(b) rest solely with the Market Maker Broker-Dealer, and GSEC has no responsibility with respect to such Market Maker Broker-Dealer’s compliance with its close-out obligations. See 17 CFR 242.204(d); see also Rule 204 Adopting Release, 74 FR at 38273-38274. GSEC will ensure that its allocation notifications to Market Maker Broker-Dealers (and to any other broker-dealer clients to which GSEC may allocate close-out responsibility pursuant to Rule 204(d)) are clear as to the number of shares being allocated and that an allocation of legal responsibility is being made under Rule 204(d). In this regard, there will be a clear distinction between a notification representing a Rule 204(d) allocation and a notification in which GSEC attributes to a client the economic cost of GSEC complying with its own Rule 204(a) obligation (*i.e.*, a buy-in) and thereby passes shares (and the cost thereof) to the client. See Rule 204 Adopting Release, 74 FR at 38274 n. 102.

¹⁷ GSEC also represents that, as part of the New Approach, it will establish, maintain and enforce certain written policies and procedures that are reasonably designed to address certain subsequent trading activity on the date of a Rule 203(b)(3) close-out. See 17 CFR 242.203(b)(3). Such written policies and procedures will be consistent with the firm’s written policies and procedures to address certain subsequent trading activity on a Rule 204 close-out date, with the exception of differences necessary to account for the

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Specifically, when GSEC has a Rule 204 close-obligation, GSEC will identify the person or persons for which GSEC clears trades or from which GSEC receives trades for settlement (including broker-dealers as well as non-broker-dealers,¹⁸ but excluding Market Maker Broker-Dealers to which GSEC allocates a portion of its net fail to deliver position pursuant to Rule 204(d)) (“Clients”)¹⁹ that caused or contributed to the firm’s net fail to deliver to CNS.²⁰ GSEC will identify the relevant Clients and determine the number of shares attributable to each such Client using a reasonably designed and consistently applied method, taking into account the trade date net trading activity and the net short position of each Client.²¹

As part of the New Approach, to the extent that GSEC purchases²² shares to satisfy its Rule 204 obligation in a security and, based on the aforementioned attribution methodology,

requirements of Rule 203(b)(3) regarding fail to deliver positions in a threshold security that have persisted for thirteen consecutive settlement days. Accordingly, GSEC respectfully requests that the Division staff provide assurances that it will not recommend to the Commission enforcement action pursuant to Rule 203(b)(3) regarding trading activity on the date that GSEC effects a close-out if GSEC establishes, maintains and enforces the New Approach in this manner.

¹⁸ To the extent that GSEC avails itself of Division staff’s no-action position with respect to multi-day close-out credit, GSEC will only claim close-out credit for net purchases by broker-dealer clients. See letter from Josephine J. Tao, Assistant Director, Division of Trading and Markets, SEC, to Robert L.D. Colby, Executive Vice President and Chief Legal Officer, Financial Industry Regulatory Authority, Inc., and Timothy H. Thompson, Senior Vice President and Chief Regulatory Officer, Chicago Board Options Exchange, Incorporated, C2 Options Exchange, Incorporated, dated Sept. 6, 2013 (“Multi-Day Close-Out Credit Letter”) available at <http://www.sec.gov/divisions/marketreg/mr-noaction/2013/finra-cboe-c2-090613-201.pdf>.

¹⁹ GSEC will identify a Client by tax identification number and will not identify a Client as a single sub-unit or as sub-units of or within the Client (*i.e.*, specific account(s) or aggregation unit(s) of the Client), except as provided in note 14, *supra*. Aggregation units are a specific exception under Rule 200(f) to the firm-wide netting required for order marking under Regulation SHO. See 17 CFR 242.200(f).

²⁰ GSEC understands that the identification of and notification to Clients that caused or contributed to GSEC’s net fail to deliver to CNS as described in this letter is not an allocation under Rule 204(d) and that, as such, GSEC does not transfer legal responsibility for complying with Rule 204 to such Clients.

²¹ GSEC will not attribute fails to deliver in a manner designed to create an unfair advantage for a particular Client, allocated broker-dealer or GSEC.

²² When GSEC borrows shares to satisfy its Rule 204 obligation in a security, it does not use the aforementioned attribution methodology to pass the costs associated with borrowing those particular shares to specific Covered Clients as it does when it purchases shares. GSEC borrows shares in the aggregate to meet the Firm’s overall needs in a security, including its delivery obligations. GSEC recognizes that, to satisfy a Rule 204 close-out obligation, in whole or in part, by borrowing shares, GSEC must borrow shares by no later than the beginning of regular trading hours on the morning of a Rule 204 close-out date. Because securities loans provide for same-day settlement, once shares that GSEC has borrowed to satisfy all or a portion of its Rule 204 obligation are delivered to GSEC’s account at Depository Trust Company, GSEC immediately delivers those shares to CNS (assuming no segregation deficit). Accordingly, the amount of the aggregate borrow will be applied to reduce GSEC’s net delivery obligation to CNS in that

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passes the purchased shares and the costs thereof through to Clients (each such Client, a “Covered Client”), GSEC will:

- prepare and provide the Covered Client with a written notice which will: (i) specify the security and number of shares that will be passed to the Covered Client on that day (the “Specified Quantity”) and (ii) inform the Covered Client that, in connection with GSEC’s compliance with its obligations under Rule 204, GSEC requires the Covered Client to end the day on the close-out date as a “net purchaser” of a number of shares at least equal to the Specified Quantity;²³ and
- on a retrospective basis (*i.e.*, on the day after the applicable close-out date, looking back at the applicable close-out date), monitor whether each Covered Client ended the day on the close-out date as a “net purchaser”²⁴ of a number of shares at least equal to the corresponding Specified Quantity, as reflected on GSEC’s books and records.

If GSEC determines that a Covered Client did not, on the applicable Rule 204 close-out date, end the day as a “net purchaser” of a number of shares of the relevant security at least equal to the corresponding Specified Quantity,²⁵ GSEC will:

security and will be reflected, along with all other deliveries and receipts, in GSEC’s net settlement obligation in the security for that settlement date. To the extent that all or a portion of GSEC’s Rule 204 obligation has not been satisfied (by borrowing or otherwise) by the beginning of trading hours on the morning of the Rule 204 close-out date, GSEC will purchase shares to satisfy its Rule 204 close-out obligation and will apply the New Approach to such purchases. If GSEC’s practices should change in a relevant and material respect, GSEC understands that it must notify the Division staff.

²³ While GSEC has sole responsibility for the provision of these notices and the other notices described in this letter to Covered Clients, when a Covered Client is one whose account is introduced to GSEC by an introducing broker-dealer that has a clearing agreement with GSEC (an “Introduced Covered Client”), GSEC may require the introducing broker-dealer to forward any notices described herein to the Introduced Covered Client with a copy to GSEC or GSEC may send the notices directly to the Introduced Covered Client.

²⁴ The “net purchaser” calculation will be applied to the entire Covered Client and not to a single sub-unit or to sub-units of or within the Covered Client (*i.e.*, a specific account or aggregation unit of the Covered Client). *See, supra*, note 19. Consistent with the conditions of the Multi-Day Close-Out Credit Letter, when GSEC determines whether a Covered Client ended the day on a close-out date as a “net purchaser” of a number of shares of the relevant security at least equal to the Specified Quantity, GSEC will recognize purchase and sale transactions occurring as a result of options exercises on the day exercised and purchase and sale transactions occurring as a result of options assignments on the business day after assignment.

²⁵ GSEC will make this determination based on its records of client positions and transactions to be cleared and settled through GSEC, including information that the Covered Client provided to GSEC regarding the terms of trades that the client executed “away” (*i.e.*, through another broker-dealer).

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- provide the Covered Client, prior to the beginning of regular trading hours on the trading day following the applicable close-out date, with a written notice indicating that (i) the Covered Client did not, on the applicable close-out date, end the day as a “net purchaser” of a number of shares of the relevant security at least equal to the Specified Quantity; and (ii) GSEC will buy-in the Covered Client for the amount of shares that, when added to the Covered Client’s net trading activity on the applicable close-out date, as reflected on GSEC’s books and records, would have been required to make the Covered Client a “net purchaser” of the Specified Quantity on the close-out date, regardless of the Covered Client’s position or activity on the trading day following the applicable close-out date; the notice will also remind the Covered Client that, in connection with GSEC’s compliance with its obligations under Rule 204, GSEC requires the Covered Client to end the day on a close-out date as a “net purchaser” of a number of shares at least equal to the Specified Quantity; and
- no later than the beginning of regular trading hours on the trading day following the applicable close-out date, buy-in the Covered Client for the amount of shares that, when added to the Client’s net trading activity on the applicable close-out date, as reflected on GSEC’s books and records, would have been required to make the Covered Client a “net purchaser” of the Specified Quantity on the close-out date, regardless of the Covered Client’s position or activity on the trading day following the applicable close-out date.²⁶

GSEC will also establish, maintain and enforce written policies and procedures that are reasonably designed to monitor the trading activity of Covered Clients and detect whether a Covered Client has engaged in a pattern of trading activity that could be used to re-establish the Covered Client’s short position and thus potentially extend GSEC’s fail to deliver to CNS. If GSEC detects such a pattern of trading activity by a Covered Client, GSEC will:

- notify the Covered Client that GSEC has identified that the Covered Client has engaged in a pattern of trading activity that could be used to re-establish the Covered Client’s short position and thus potentially extend GSEC’s fail to deliver to CNS;
- escalate issues relating to such conduct to GSEC’s Compliance Department, which, in conjunction with other appropriate GSEC personnel, will determine whether any other action should be taken in light of all relevant facts and circumstances;
- make and keep accurate books and records, specifically identifying (i) the Covered Client that GSEC identified as being engaged in such a pattern of trading activity; (ii) any

²⁶ GSEC may conduct this supplemental buy-in through the entry of a volume weighted average price, or VWAP, order that satisfies the conditions of footnote 66 of the Rule 204 Adopting Release. *See* Rule 204 Adopting Release, 74 FR at 38271 n. 66.

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actions that GSEC took in response; and (iii) any information or explanation provided by the Covered Client.

Under the New Approach, to the extent that GSEC commits its own capital to purchase the shares (rather than assigning the economic cost to Clients), GSEC represents that its firm accounts will end the day on the close-out date as a “net purchaser” of a number of shares of the relevant security at least equal to the amount of the fail to deliver position closed-out by the firm accounts. The firm’s representation is contingent on its continuing to have a business model in which GSEC acquires positions in firm accounts only in limited circumstances such as addressing errors and complying with buy-in and close-out requirements and in which GSEC does not engage in principal trading in furtherance of customer facilitation or market making activity, or otherwise. If GSEC’s business model should change in a relevant and material respect, GSEC understands that it must notify the Division staff.

In addition, under the New Approach, securities in which GSEC has a Rule 204 close-out obligation will not appear on the Easy-to-Borrow (“ETB”) list for the applicable close-out date and, accordingly, GSEC will not utilize the ETB list to grant locates for such securities on the applicable close-out date. As a result, on such date, locate requests in those securities will be evaluated on a case-by-case basis, either by an automated locate tool or manually by a Goldman, Sachs & Co. Securities Lending representative.²⁷

GSEC will make and keep accurate books and records as required by the federal securities laws, including books and records sufficient to demonstrate that GSEC is following the terms of the New Approach as described in this letter, and will promptly provide such records to the Commission upon request.

GSEC believes that, consistent with the representations above, the proposed no-action relief will both address the operational and practical difficulties that GSEC faces and further the central goal of Rule 204 to reduce fails to deliver to CNS. Accordingly, based on the foregoing, GSEC respectfully requests that the Division staff provide assurances that it will not recommend to the Commission enforcement action pursuant to Rule 204(a) regarding subsequent trading activity on the date that GSEC effects a close-out if GSEC establishes, maintains and enforces the New Approach.

²⁷ GSEC does not have its own securities lending group, and instead utilizes the services of the Securities Lending group within its affiliate Goldman, Sachs & Co.

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If you have any questions regarding this matter, please do not hesitate to contact me at (202) 663-6588 or Harry J. Weiss at (202) 663-6993.

Sincerely,



Beth A. Stekler



DIVISION OF
TRADING AND MARKETS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

April 26, 2017

Larry E. Bergmann, Esq.
Murphy & McGonigle, P.C.
555 Thirteenth Street, N.W.
Washington, DC 20004

**Re: Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Creations of Covered ETF Shares for Close-Out Purposes and for Confirmation regarding the Treatment of Executed Creations and Executed Redemptions of Covered ETF Shares for Pre-Fail and Post-Fail Credit Purposes under the Multi-Day Close-Out Credit Letter
TP File No 17-08**

Dear Mr. Bergmann:

In your letter dated April 26, 2017 (“Letter”), Murphy & McGonigle, P.C., on behalf of Latour Trading LLC (“Latour” or the “Firm”), a broker-dealer that is an exchange-registered market maker in exchange-traded products, requests assurances that the staff of the Division of Trading and Markets of the Securities and Exchange Commission (the “Commission”) will not recommend to the Commission enforcement action under Rule 204 of Regulation SHO (“Rule 204”) under the Securities Exchange Act of 1934 (the “Exchange Act”),¹ if the Firm, consistent with the approach described in your Letter, closes out a fail to deliver position in the securities of certain exchange-traded products² by submitting, no later than the beginning of regular trading hours on the applicable close-out date, irrevocable instructions to create shares in the covered ETF for which the Firm has a Rule 204(a) close-out obligation through an Authorized Participant

¹ 17 CFR 242.204; *see* Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 (July 31, 2009) (“Rule 204 Adopting Release”).

² The request for relief is limited to the securities of exchange-traded products meeting the following conditions: (1)(a) the securities are issued at net asset value by an open-end investment company or unit investment trust registered with the Commission under the Investment Company Act of 1940 (the “40 Act”) that engages in a continuous offering of its securities, or (b) the securities are issued at net asset value by a pooled investment vehicle (e.g., a trust or a partnership) that engages in a continuous offering of its securities but that is not an investment company registered under the 40 Act; and (2) the securities are listed and traded on a national securities exchange. For purposes of this letter, exchange-traded products whose securities satisfy conditions (1) and (2) collectively shall be referred to as “covered ETFs.”

(“AP”) of the covered ETF (hereinafter, “Creation Order”).³ You also seek confirmation that shares of a covered ETF purchased through the execution of a Creation Order or shares of a covered ETF sold through the execution of a redemption request submitted through an AP of the covered ETF (hereinafter, “Redemption Order”) should be treated in the same manner as purchases or sales of shares of the covered ETF in the secondary market, under the Multi-Day Close-Out Credit Letter (as defined below),⁴ when calculating daily net purchases for purposes of Credit (as that term is defined in the Multi-Day Close-Out Credit Letter). A copy of your Letter is attached to this response. By including a copy of your correspondence, we avoid having to repeat or summarize all of the facts you presented. The defined terms in this letter have the same meaning as in your Letter, unless otherwise noted.

Rule 204 requires a participant of a registered clearing agency⁵ (“Participant”) to deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or to close-out 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 by borrowing or purchasing securities of like kind and quantity.⁶ The Participant must close-out a fail to deliver position for a short sale transaction “by no later than the beginning of regular trading hours on the settlement day following the settlement date.”⁷ If a Participant has a fail to deliver position that the Participant can demonstrate on its books and records resulted from a long sale, or 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 must close-out the fail to deliver position “by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date.”⁸ In the Rule 204 Adopting Release, the Commission specified that to meet its close-out obligation, among other things, a Participant 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 by no later than the beginning of regular trading hours.⁹

Pursuant to Rule 204(d), a Participant with a close-out obligation may reasonably allocate a portion of its fail to deliver position to another registered broker or dealer (“Allocated Broker-

³ When an ETF creates new shares, the ETF issues shares in blocks (blocks of 50,000 shares, for example) that are known as “creations.” See *infra* note 12.

⁴ Letter from Josephine J. Tao, Assistant Director, Division of Trading and Markets, SEC, to Robert L.D. Colby, Executive Vice President and Chief Legal Officer, Financial Industry Regulatory Authority, Inc., and Timothy H. Thompson, Senior Vice President and Chief Regulatory Officer, Chicago Board Options Exchange, Inc., C2 Options Exchange, Inc., dated September 6, 2013 (“Multi-Day Close-Out Credit Letter”).

⁵ For purposes of Regulation SHO, the term “participant” has the same meaning as in Section 3(a)(24) of the Exchange Act, 15 U.S.C. 78c(a)(24). See Rule 204 Adopting Release, 74 FR at 38268 n.34.

⁶ 17 CFR 242.204(a).

⁷ 17 CFR 242.204(a). For purposes of Rule 204, “regular trading hours” has the same meaning as in Rule 600(b)(64) of Regulation NMS. See Rule 204 Adopting Release, 74 FR at 38269 n.44; 17 CFR 242.600(b)(64).

⁸ 17 CFR 242.204(a)(1) and (a)(3).

⁹ Rule 204 Adopting Release, 74 FR at 38272.

Dealer”) for which it clears trades or from which it receives trades for settlement, based on such Allocated Broker-Dealer’s short position.¹⁰ Rule 204(a) applies to such Allocated Broker-Dealer with respect to the allocated portion of the fail to deliver position.¹¹ Your Letter indicates that Latour receives allocations of fail to deliver positions from Participants under Rule 204(d).

When a broker-dealer submits an instruction to create ETF shares through an AP, the creation process involves steps that occur after the beginning of regular trading hours.¹² As a result, ETF share creations are not completed until after the beginning of regular trading hours.

You request assurances regarding the use of an approach, as described in your Letter, related to covered ETF share creations. Specifically, you propose an approach in which Latour would close-out a fail to deliver position in the securities of a covered ETF by submitting an irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date (the “ETF Creation Approach”).¹³ You represent Latour’s belief that the use of the ETF Creation Approach is consistent with the policy of enforcing the strict close-out requirements of Rule 204(a) as it requires the Firm to take affirmative action and irrevocably commit itself to purchase the covered ETF shares within the timeframes set forth in Rule 204(a).

Based on the facts and representations in your Letter, the staff would not recommend to the Commission enforcement action under Rule 204 for failing to “immediately close out” a fail to deliver position in the shares of a covered ETF “no later than the beginning of regular trading hours on the [applicable close-out] settlement day” by “purchasing securities of like kind and quantity” if, consistent with the approach you describe in your Letter, the Firm submits an irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date in accordance with the representations in your Letter, which are reproduced below.¹⁴

¹⁰ 17 CFR 242.204(d).

¹¹ *Id.*

¹² The process of creating and redeeming ETF shares in “creation unit” aggregations is described generally in Securities Act Release No. 8901 (March 11, 2008), 73 FR 14618,14628 (March 18, 2008), and Securities Act Release No. 9922 (September 22, 2015), 80 FR 62274, 62276-77 (October 15, 2015). Typically, in an ETF creation the submitting party (*e.g.*, Latour in this instance) sends a Creation Order to the AP, causing the AP to initiate the creation process. The AP will acknowledge receipt of the Creation Order to the Participant or Allocated Broker-Dealer, submit the Creation Order to the ETF or an authorized agent of the ETF and confirm the issuance of the ETF shares to the Participant or Allocated Broker-Dealer. The creation is a two-sided transaction: the ETF provides new ETF shares in exchange for receipt of the underlying securities, cash, or a combination of the underlying securities and cash from the AP. Both legs are priced identically (at the net asset value of the ETF at the end of the day).

¹³ The request does not include Creations Orders that are not submitted directly to an AP of the covered ETF, for instance, through another broker-dealer that is not an AP of the covered ETF or a broker-dealer that is not accepting or receiving the Creation Order in its capacity as an AP of the covered ETF.

¹⁴ For the avoidance of doubt, this no-action relief solely addresses the issue of whether the submission of an irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date, consistent with the approach described in your Letter, constitutes

1. The Creation Order, along with other actions the Firm may take to close-out its fail to deliver position,¹⁵ is for the full amount of the fail to deliver position subject to the close-out obligation in Rule 204 in the shares of the covered ETF.
2. The Firm will submit the Creation Order directly to an AP that is authorized to create or redeem shares for the covered ETF.¹⁶
3. The Firm has a relationship with the AP of the covered ETF to which it directly submits the Creation Order to engage in creations and redemptions of shares of the covered ETF.¹⁷ The Firm reasonably believes that the AP will be able to facilitate and fulfill the execution of the Creation Order with the covered ETF based on the AP's past pattern and practice regarding creations and redemptions in covered ETF shares on behalf of the Firm. The Firm will not utilize an AP that has a pattern or practice of failed creations of covered ETF shares when it receives a Creation Order from the Firm, unless the Firm reasonably believes that the AP has implemented timely corrective measures that have remediated the issues that were resulting in Creation Orders not being filled.
4. The Firm's Creation Order will be irrevocable and will not be modified or canceled by the Firm ("Irrevocable Creation Order").
5. The Irrevocable Creation Order will be *bona fide* and the Firm will have no reason to believe that it will not be filled in its entirety by the covered ETF.¹⁸

"purchasing securities of like kind and quantity" by "no later than the beginning of regular trading hours on the [applicable close-out] settlement day" under Rule 204(a). This relief does not address any other issue under Rule 204(a), except as provided in note 15, *infra*, and except with respect to calculating daily net purchases for purposes of Credit under the Multi-Day Close-Out Credit Letter. See 17 CFR 242.204(a); Rule 204 Adopting Release. This relief also does not address any issue under any other provision of Regulation SHO relating to ETF creations and redemptions, including, without limitation, the calculation of net position for purposes of order marking under Rule 200.

¹⁵ In some cases, Latour may satisfy its close-out obligation to "borrow[] or purchas[e] securities of like kind and quantity" by acquiring the requisite amount of covered ETF shares through a combination of Creation Orders, irrevocable volume-weighted-average-price ("VWAP") orders for covered ETF shares, and/or a borrow of covered ETF shares. The Commission has permitted the use of VWAP orders to satisfy the requirement to "borrow[] or purchas[e] securities" by "no later than the beginning of regular trading hours" 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." See Rule 204 Adopting Release, 74 FR at 38271 n.66. In these circumstances, the Firm will note in its books and records the combination of Creation Orders, VWAP orders, and/or borrows that satisfies the specific obligation to "borrow[] or purchas[e] securities of like kind and quantity" under Rule 204(a).

¹⁶ See *supra* note 13.

¹⁷ Although not required to satisfy this representation, a written agreement between Latour and the AP would be strong evidence of the relationship with the AP to create and redeem shares of the covered ETF.

¹⁸ For instance, the Firm's policies and procedures will provide that it will not engage in transactions with an AP or a covered ETF for the creation of shares of a covered ETF through an Irrevocable Creation Order for the purpose of closing-out a fail to deliver position if the Firm knows or has reason to know that the covered ETF or

6. The Firm will submit the Irrevocable Creation Order to the AP by no later than the beginning of regular trading hours on the applicable close-out date, and will note in its books and records that the Irrevocable Creation Order is in satisfaction, in whole or in part, of the Firm's obligation to "purchas[e] securities of like kind and quantity" under Rule 204(a).
7. The Firm has a reasonable expectation that the AP will confirm that the Irrevocable Creation Order has been filled in its entirety after the close of regular trading hours on the applicable close-out date.
8. If, despite the Firm having submitted an Irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date:
 - (i) the Firm is subsequently on notice before 3:30 p.m. Eastern Time on the close-out date that the Irrevocable Creation Order will not be filled (in whole or part in an amount sufficient to cover the close-out obligation) by the covered ETF, or will not be successfully submitted by the AP to the covered ETF on the close-out date by the deadline established by the covered ETF, the Firm will purchase or borrow¹⁹ covered ETF shares of like kind and quantity in the amount necessary to close-out the Firm's fail to deliver position, as calculated prior to beginning of regular trading hours on the close-out date ("original fail to deliver position") (less any shares in partial fulfillment of the Irrevocable Creation Order), prior to the end of regular trading hours on the close-out date; or
 - (ii) the Irrevocable Creation Order was not filled (in whole or part in an amount sufficient to cover the original fail to deliver position) by the covered ETF after 3:30 p.m. Eastern Time on the close-out date, the Firm will, no later than the beginning of regular trading hours on the following trading day ("next trading day"), purchase or

AP will not deliver the covered ETF shares in settlement of the Irrevocable Creation Order (*i.e.*, a "sham close-out"). *See* 17 CFR 242.204(f); Rule 204 Adopting Release, 74 FR at 38278.

¹⁹ In a 2014 letter granting no-action relief to Goldman Sachs Execution & Clearing, L.P. ("GSEC"), the staff stated that "[t]o satisfy a close-out obligation by borrowing shares, the Participant must enter into a legally binding agreement with the lender to borrow/loan shares (in accordance with the terms of a securities lending agreement) by no later than the beginning of regular trading hours on the Rule 204 close-out date." Letter from Josephine J. Tao, Assistant Director, Division of Trading and Markets, SEC, to Beth A. Stekler, Wilmer Cutler Pickering Hale and Dorr, LLP, dated October 27, 2014 at n.14. As with other no-action letters, the staff made clear in the letter that the staff's "position is based solely on the representations in [the] October 27, 2014 letter and the representations and facts [the writer] presented to Division staff." *Id.* at 4. In that regard, the staff notes in particular that the October 27, 2014 letter requesting no-action relief stated the following in discussing GSEC's use of borrows to satisfy its Rule 204 close-out obligation in a security: "[b]ecause securities loans provide for same-day settlement, once shares that GSEC has borrowed to satisfy all or a portion of its Rule 204 obligation are delivered to GSEC's account at Depository Trust Company, GSEC immediately delivers those shares to CNS (assuming no segregation deficit). *Accordingly, the amount of the aggregate borrow will be applied to reduce GSEC's net delivery obligation to CNS in that security and will be reflected, along with all other deliveries and receipts, in GSEC's net settlement obligation in the security for that settlement date.*" Letter from Beth A. Stekler, Wilmer Cutler Pickering Hale and Dorr, LLP, to Josephine J. Tao, Assistant Director, Division of Trading and Markets, SEC, dated October 27, 2014 ("GSEC Request Letter") at n. 22 (emphasis added). The GSEC Request Letter did not raise the possibility of so-called "dropped" borrows.

borrow covered ETF shares of like kind and quantity in the amount necessary to close-out the original fail to deliver position (less any shares in partial fulfillment of the Irrevocable Creation Order).²⁰

In determining the number of shares necessary to close-out the original fail to deliver position pursuant to (i) or (ii) above, the Firm will not take credit for any trading or borrowing activity, or continuous net settlement activity, that occurs between the beginning of regular trading hours on the close-out date and the beginning of regular trading hours on the next trading day (except for any shares in partial fulfillment of the Irrevocable Creation Order). In addition, the Firm will note in its books and records the combination of partially filled Creation Orders, purchases, and/or borrows that satisfies the obligation to close-out the original fail to deliver position pursuant to (i) or (ii) above.

9. The Firm has a reasonable expectation that its creation of covered ETF shares will settle at the applicable Participant's account at the National Securities Clearing Corporation (or other appropriate registered clearing agency) on the same time frame as would a secondary market purchase of covered ETF shares made no later than the beginning of regular trading hours on the applicable close-out date.
10. The Firm will not use an Irrevocable Creation Order to satisfy a close-out obligation on an applicable close-out date for the shares of any covered ETF that has announced, prior to the beginning of regular trading hours on the applicable close-out date, a restriction or limitation on issuances or creations.
11. The Firm will establish, maintain, and enforce written policies and procedures reasonably designed so that the Firm will have no reason to believe that a substantial proportion of the securities, cash, or collateral required for settlement of the Irrevocable Creation Order transaction will not be delivered to the covered ETF on the day that delivery is due.
12. The Firm will establish, maintain, and enforce written policies and procedures reasonably designed to achieve and surveil for compliance with its Rule 204 close-out obligations using Irrevocable Creation Orders, including written policies and procedures to monitor the performance of the covered ETF, AP, and the Firm, as appropriate, for any pattern of actions that results in the Irrevocable Creation Order not being filled (in whole or in part), including failure to confirm or complete the creation of shares of the covered ETF; rejection, revocation, or cancellation of the Irrevocable Creation Order; or other actions that would result in the Irrevocable Creation Order not being filled. The policies and procedures will require the Firm to examine the cause of a failure to fill an Irrevocable Creation Order and consider whether any action should be taken in light of all the facts and circumstances.
13. The Firm will maintain accurate books and records that evidence the use of Irrevocable Creation Orders to comply with its Rule 204 close-out requirement and that evidence compliance with the representations reproduced in this letter, and that will be provided to

²⁰ Purchasing or borrowing activity to close-out the original fail to deliver position by no later than the beginning of regular trading hours on the next trading day is independent of any new close-out obligation on the next trading day and will have no effect on the Firm's close-out obligation under Rule 204 for the next trading day.

the staff of the Commission or appropriate self-regulatory organization (“SRO”) upon request.²¹

14. The Firm recognizes that it is subject to all other requirements in Rule 204 related to its close-out obligation.

ETF Creation and Redemption Multi-Day Approach

You also seek confirmation that the Firm would be permitted to count the shares of a covered ETF purchased through executed Creation Orders or shares of a covered ETF sold through executed Redemption Orders in the same manner as purchases or sales of shares of the covered ETF in the secondary market when calculating daily net purchases for purposes of Credit under the Multi-Day Close-Out Credit Letter (“ETF Creation and Redemption Multi-Day Approach”).²² You represent Latour’s belief that the ETF Creation and Redemption Multi-Day Approach furthers the Commission’s purpose in adopting Rule 204(e) of encouraging broker-dealers to close-out fails to deliver prior to the applicable close-out date. The staff hereby confirms that the Firm would be permitted to count shares of a covered ETF purchased through executed Creation Orders or shares of a covered ETF sold through executed Redemption Orders submitted through an AP of the covered ETF in the same manner as purchases or sales of shares of the covered ETF in the secondary market when calculating Credit under the Multi-Day Close-Out Credit Letter, consistent with the approach you describe in your Letter and subject to the terms of the Multi-Day Close-Out Credit Letter.

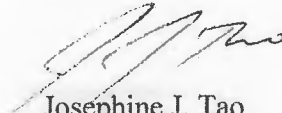
²¹ The Firm’s records will include communications with the AP or the covered ETF, if applicable, and any action taken to address a pattern of failure to complete Irrevocable Creation Orders by the AP or the covered ETF.

²² Unlike the ETF Creation Approach described above, the ETF Creation and Redemption Multi-Day Approach addresses executed Creation Orders and executed Redemption Orders. Issues concerning the timing of creations in the context of the ETF Creation Approach do not arise in the context of calculating Credit under the Multi-Day Close-Out Credit Letter because Credit is calculated as of the end of the day (i.e., after the Firm knows whether a Creation Order or Redemption Order has been executed).

Conclusion

These staff positions are with respect to enforcement only, and do not purport to express any legal conclusions regarding the application of the federal securities laws. These positions are subject to modification or revocation if at any time the staff determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act. These positions are based on the facts you have presented and the representations you have made in your Letter and are strictly limited to the application of the ETF Creation Approach and the ETF Creation and Redemption Multi-Day Approach as described above and in your Letter. Any different facts or circumstances may require a different response. The staff expresses no view with respect to any other questions that the proposed activities may raise, including, but not limited to, the applicability of any other federal or state laws or SRO rules to the proposed activities.

Sincerely,



Josephine J. Tao
Assistant Director

Attachment

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McGONIGLE**
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April 26, 2017

Josephine J. Tao, Esq.
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U.S. Securities and Exchange Commission
100 F Street, N.E.
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Re: Request for No-Action Relief under Rule 204 of Regulation SHO with respect to Creations of Covered ETF Shares for Close-Out Purposes and for Confirmation regarding the Treatment of Executed Creations and Executed Redemptions of Covered ETF Shares for Pre-Fail and Post-Fail Credit Purposes under the Multi-Day Close-Out Credit Letter

Dear Ms. Tao:

Murphy & McGonigle, P.C., on behalf of Latour Trading LLC (“Latour” or “Firm”), a broker-dealer that is an exchange-registered market maker in exchange traded products, respectfully requests that the staff of the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (“Commission” or “SEC”) provide assurances that it will not recommend to the Commission enforcement action under Rule 204 of Regulation SHO (“Rule 204”) under the Securities Exchange Act of 1934 (the “Exchange Act”),¹ if the Firm closes-out a fail to deliver position in the securities of certain exchange-traded products² by

¹ See 17 CFR 242.204; Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 (July 31, 2009) (“Rule 204 Adopting Release”).

² Our request for relief is limited to the securities of exchange-traded products meeting the following conditions: (1)(a) the securities are issued at net asset value by an open-end investment company or unit investment trust registered with the Commission under the Investment Company Act of 1940 (the “40 Act”) that engages in a continuous offering of its securities, or (b) the securities are issued at net asset value by a pooled investment vehicle (e.g., a trust or a partnership) that engages in a continuous offering of its securities but that is not an investment company registered under the 40 Act; and (2) the securities are listed and traded on a national securities exchange. For purposes of this letter, exchange-traded products whose securities satisfy conditions (1) and (2) collectively shall be referred to as “covered ETFs”.

submitting, no later than the beginning of regular trading hours³ on the applicable close-out date, irrevocable instructions⁴ to create shares in the covered ETF for which the Firm has a Rule 204(a) close-out obligation through an Authorized Participant (“AP”) of the covered ETF (hereinafter, “Creation Order”) in accordance with the approach described below.⁵ We also seek confirmation that shares of a covered ETF purchased through the execution of a Creation Order or shares of a covered ETF sold through the execution of a redemption request submitted through an AP of the covered ETF (hereinafter, “Redemption Order”) should be treated in the same manner as purchases or sales of shares of the covered ETF in the secondary market, under the Multi-Day Close-Out Credit Letter (as defined below),⁶ when calculating daily net purchases for purposes of Credit (as that term is defined in the Multi-Day Close-Out Credit Letter), as described in more detail below.

Regulation SHO Close-Out Requirement under Rule 204

Under Rule 204, a participant of a registered clearing agency⁷ (“Participant”) must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or must close-out a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity.⁸ The Participant must close-out a fail to deliver position for a short sale transaction “by no later than the beginning of regular trading hours on the settlement day following the settlement date,” referred to as T+4.⁹ If a Participant has a fail to deliver position that the Participant can demonstrate on its books and records resulted from a long sale, or 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 must close-out the fail to deliver position “by no later

³ For purposes of Rule 204, “regular trading hours” has the same meaning as in Rule 600(b)(64) of Regulation NMS. 17 CFR 242.204(g)(2).

⁴ The “instruction” will be a *bona-fide* Irrevocable Creation Order submitted directly to the AP, as described below. *See infra* pp. 4-5.

⁵ When an ETF creates new shares, the ETF issues shares in blocks (blocks of 50,000 shares, for example) that are known as “creations.” *See infra* note 16.

⁶ *See* Letter from Josephine J. Tao, Assistant Director, Division of Trading and Markets, SEC, to Robert L.D. Colby, Executive Vice President and Chief Legal Officer, Financial Industry Regulatory Authority, Inc., and Timothy H. Thompson, Senior Vice President and Chief Regulatory Officer, Chicago Board Options Exchange, Inc., C2 Options Exchange, Inc., dated September 6, 2013 (“Multi-Day Close-Out Credit Letter”), available at <https://www.sec.gov/divisions/marketre/mr-noaction/2013/finra-cboe-c2-090613-201.pdf>.

⁷ For purposes of Regulation SHO, the term “participant” has the same meaning as in Section 3(a)(24) of the Exchange Act, 15 U.S.C. 78c(a)(24). *See* Rule 204 Adopting Release, 74 FR at 38268 n.34.

⁸ 17 CFR 242.204(a).

⁹ *Id.* Generally, transactions in most ETFs settle within three settlement days, known as T+3. *See infra* the text accompanying note 22.

than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, referred to as T+6.¹⁰ In the Rule 204 Adopting Release, the Commission specified that to meet its close-out obligation, among other things, a Participant 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 by no later than the beginning of regular trading hours.¹¹

Pursuant to Rule 204(d), a Participant with a close-out obligation may reasonably allocate a portion of its fail to deliver position to another registered broker or dealer (“Allocated Broker-Dealer”) for which it clears trades or from which it receives trades for settlement, based on such Allocated Broker-Dealer’s short position.¹² Rule 204(a) applies to such Allocated Broker-Dealer with respect to the allocated portion of the fail to deliver position.¹³ Latour receives allocations of fail to deliver positions from Participants under Rule 204(d).

Proposed Approach to Utilize Newly-Created Covered ETF Shares to Close-Out Open Fails to Deliver

Latour takes its obligations to comply with Rule 204 seriously and respects the Commission’s concern regarding fails to deliver and the important role that Rule 204 plays in efforts by the Commission to address fails to deliver. Latour therefore requests assurances that the Division would not recommend enforcement action under Rule 204 for failing to “immediately close out” a fail to deliver position in the shares of a covered ETF “no later than the beginning of regular trading hours on the [applicable close-out] settlement day” by “purchasing securities of like kind and quantity”¹⁴ if the Firm, when it has a close-out obligation

¹⁰ 17 CFR 242.204(a)(1) and (a)(3). As discussed below, the close-out obligation can be allocated by a Participant to another broker-dealer pursuant to Rule 204(d). Fails to deliver due to sales resulting from options exercises or assignments must be closed-out in accordance with Rule 204. See Letter from Josephine J. Tao, Assistant Director, Division of Trading and Markets, SEC, to Beth A. Stekler, Partner, Wilmer Cutler Pickering Hale and Dorr LLP, dated October 27, 2014 (“Goldman Letter”) at 2-3 n.9, available at <https://www.sec.gov/divisions/marketreg/mr-noaction/2014/goldman-090613-204.pdf>. However, because application of the locate requirement in Rule 203(b)(1) to short sales resulting from options exercises or assignments presently raises certain operational difficulties, broker-dealers do not need to obtain a locate with respect to short sales that result from options exercises or assignments. The Commission and its staff have also noted that short sales pursuant to options exercises and assignments are not subject to Rule 201 of Regulation SHO. See Exchange Act Release No. 61595 (February 26, 2010), 75 FR 11232, 11263 n.433 (March 10, 2010); Multi-Day Close-Out Credit Letter at 3 n.9.

¹¹ Rule 204 Adopting Release, 74 FR at 38272.

¹² 17 CFR 242.204(d).

¹³ *Id.*

¹⁴ For the avoidance of doubt, this request for no-action relief solely addresses the issue of whether the submission of an irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date, consistent with the approach described below, constitutes “purchasing securities of like kind and quantity” by “no later than the beginning of regular trading hours on the [applicable close-out] settlement day” under Rule 204(a). This request for relief does not address any other issue under Rule 204(a), except as provided in note 17, *infra*, and except with respect to calculating daily net

pursuant to Rule 204(a) with respect to the shares of the covered ETF, closes-out its fail to deliver position in those shares by submitting¹⁵ an irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date in accordance with the representations below (the “ETF Creation Approach”):¹⁶

- The Creation Order, along with other actions the Firm may take to close-out its fail to deliver position,¹⁷ is for the full amount of the fail to deliver position subject to the close-out obligation in Rule 204 in the shares of the covered ETF.
- The Firm will submit the Creation Order directly to an AP that is authorized to create or redeem shares for the covered ETF.¹⁸
- The Firm has a relationship with the AP of the covered ETF to which it directly submits the Creation Order to engage in creations and redemptions of shares of the covered ETF.¹⁹ The Firm reasonably believes that the AP will be able to facilitate and fulfill the execution of the Creation Order with the covered ETF based on the AP’s past pattern and

purchases for purposes of Credit under the Multi-Day Close-Out Credit Letter, as described below. See 17 CFR 242.204(a); Rule 204 Adopting Release.

¹⁵ Our request does not include Creation Orders that are not submitted directly to an AP of the covered ETF, for instance, through another broker-dealer that is not an AP of the covered ETF or a broker-dealer that is not accepting or receiving the Creation Order in its capacity as an AP of the covered ETF.

¹⁶ The process of creating and redeeming ETF shares in “creation unit” aggregations is described generally in Securities Act Release No. 8901 (March 11, 2008), 73 FR 14618, 14628 (March 18, 2008), and Securities Act Release No. 9922 (September 22, 2015), 80 FR 62274, 62276-62277 (October 15, 2015). Typically, in an ETF creation the submitting party (e.g., Latour in this instance) sends a Creation Order to the AP, causing the AP to initiate the creation process. The AP will acknowledge receipt of the Creation Order to the Participant or Allocated Broker-Dealer, submit the Creation Order to the ETF or an authorized agent of the ETF and confirm the issuance of the ETF shares to the Participant or Allocated Broker-Dealer. The creation is a two-sided transaction: the ETF provides new ETF shares in exchange for receipt of the underlying securities, cash, or a combination of the underlying securities and cash from the AP. Both legs are priced identically (at the net asset value of the ETF at the end of the day).

¹⁷ In some cases, Latour may satisfy its close-out obligation to “borrow[] or purchas[e] securities of like kind and quantity” by acquiring the requisite amount of covered ETF shares through a combination of Creation Orders, irrevocable volume-weighted-average-price (“VWAP”) orders for covered ETF shares, and/or a borrow of covered ETF shares. The Commission has permitted the use of VWAP orders to satisfy the requirement to “borrow[] or purchas[e] securities” by “no later than the beginning of regular trading hours” 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.” See Rule 204 Adopting Release, 74 FR at 38271 n.66. In these circumstances, the Firm will note in its books and records the combination of Creation Orders, VWAP orders, and/or borrows that satisfies the specific obligation to “borrow[] or purchas[e] securities of like kind and quantity” under Rule 204(a).

¹⁸ See *supra* note 15.

¹⁹ Although not required to satisfy this representation, the Firm recognizes that a written agreement between Latour and the AP would be strong evidence of the relationship with the AP to create and redeem shares of the covered ETF.

practice regarding creations and redemptions in covered ETF shares on behalf of the Firm. The Firm will not utilize an AP that has a pattern or practice of failed creations of covered ETF shares when it receives a Creation Order from the Firm unless the Firm reasonably believes that the AP has implemented timely corrective measures that have remediated the issues that were resulting in Creation Orders not being filled.

- The Firm's Creation Order will be irrevocable and will not be modified or canceled by the Firm ("Irrevocable Creation Order").
- The Irrevocable Creation Order will be *bona fide* and the Firm will have no reason to believe that it will not be filled in its entirety by the covered ETF.²⁰
- The Firm will submit the Irrevocable Creation Order to the AP by no later than the beginning of regular trading hours on the applicable close-out date, and will note in its books and records that the Irrevocable Creation Order is in satisfaction, in whole or in part, of the Firm's obligation to "purchas[e] securities of like kind and quantity" under Rule 204(a).
- The Firm has a reasonable expectation that the AP will confirm that the Irrevocable Creation Order has been filled in its entirety after the close of regular trading hours on the applicable close-out date.
- If, despite the Firm having submitted an Irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date:
 - (i) the Firm is subsequently on notice before 3:30 p.m. Eastern Time on the applicable close-out date that the Irrevocable Creation Order will not be filled (in whole or part in an amount sufficient to cover the close-out obligation) by the covered ETF, or will not be successfully submitted by the AP to the covered ETF on the close-out date by the deadline established by the covered ETF, the Firm will purchase or borrow covered ETF shares of like kind and quantity in the amount necessary to close-out the Firm's fail to deliver position, as calculated prior to beginning of regular trading hours on the applicable close-out date ("original fail to deliver position") (less any shares in partial fulfillment of the Irrevocable Creation Order) prior to the end of regular trading hours on the close-out date; or
 - (ii) the Irrevocable Creation Order was not filled (in whole or part in an amount sufficient to cover the original fail to deliver position) by the covered ETF after 3:30 p.m.

²⁰ For instance, the Firm's policies and procedures will provide that it will not engage in transactions with an AP or a covered ETF for the creation of shares of a covered ETF through an Irrevocable Creation Order for the purpose of closing-out a fail to deliver position if the Firm knows or has reason to know that the covered ETF or AP will not deliver the covered ETF shares in settlement of the Irrevocable Creation Order (i.e., a "sham close out"). See 17 CFR 242.204(f); Rule 204 Adopting Release, 74 FR at 38278.

Eastern Time on the applicable close-out date, the Firm will, no later than the beginning of regular trading hours on the following trading day (“next trading day”), purchase or borrow covered ETF shares of like kind and quantity in the amount necessary to close-out the original fail to deliver position (less any shares in partial fulfillment of the Irrevocable Creation Order).²¹

In determining the number of shares necessary to close-out the original fail to deliver position pursuant to (i) or (ii) above, the Firm will not take credit for any trading or borrowing activity, or continuous net settlement activity, that occurs between the beginning of regular trading hours on the close-out date and the beginning of regular trading hours on the next trading day (except for any shares in partial fulfillment of the Irrevocable Creation Order). In addition, the Firm will note in its books and records the combination of partially filled Creation Orders, purchases, and/or borrows that satisfies the obligation to close-out the original fail to deliver position pursuant to (i) or (ii) above.

- The Firm has a reasonable expectation that its creation of covered ETF shares will settle at the applicable Participant’s account at the National Securities Clearing Corporation (“NSCC”) (or other appropriate registered clearing agency) on the same time frame as would a secondary market purchase of covered ETF shares made no later than the beginning of regular trading hours on the applicable close-out date.²²
- The Firm will not use an Irrevocable Creation Order to satisfy a close-out obligation on an applicable close-out date for the shares of any covered ETF that has announced, prior to the beginning of regular trading hours on the applicable close-out date, a restriction or limitation on issuances or creations.
- The Firm will establish, maintain, and enforce written policies and procedures reasonably designed so that the Firm will have no reason to believe that a substantial proportion of the securities, cash, or collateral required for settlement of the Irrevocable Creation Order transaction will not be delivered to the covered ETF on the day that delivery is due.
- The Firm will establish, maintain, and enforce written policies and procedures reasonably designed to achieve and surveil for compliance with its Rule 204 close-out obligations using Irrevocable Creation Orders, including written policies and procedures to monitor the performance of the covered ETF, AP, and the Firm, as appropriate, for any pattern of actions that results in the Irrevocable Creation Order not being filled (in whole or in part), including failure to confirm or complete the creation of shares of the covered ETF; rejection, revocation, or cancellation of the Irrevocable Creation Order; or other actions that would result in the Irrevocable Creation Order not being filled. The policies and

²¹ Purchasing or borrowing activity to close-out the original fail to deliver position by no later than the beginning of regular trading hours on the next trading day is independent of any new close-out obligation on the next trading day and will have no effect on the Firm’s close-out obligation under Rule 204 for the next trading day.

²² We recognize that, when the securities industry transitions to a shortened settlement cycle, the timeframes for actions required by Rule 204 would be adjusted accordingly.

procedures will require the Firm to examine the cause of a failure to fill an Irrevocable Creation Order and consider whether any action should be taken in light of all the facts and circumstances.

- The Firm will maintain accurate books and records that evidence the use of Irrevocable Creation Orders to comply with its Rule 204 close-out requirement and that evidence compliance with the representations contained in this letter, and that will be provided to the staff of the Commission or appropriate self-regulatory organization (“SRO”) upon request.²³
- The Firm is subject to all other requirements in Rule 204 related to its close-out obligation.

Proposed Approach for the Inclusion of Pre-Fail and Post-Fail Credits When Calculating Net Purchases

Rule 204(e) provides that, even if a Participant has not closed-out a fail to deliver position 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 may receive credit for purchases or borrows executed prior to the applicable close-out date if the broker-dealer complies with all four requirements set forth in “pre-fail credit” provision in Rule 204(e) (“Pre-Fail Credit”). Specifically, to obtain Pre-Fail Credit under Rule 204(e): (1) the purchase or borrow must be “bona fide”; (2) the purchase or borrow must be executed after the trade date but by no later than the end of regular trading hours on the settlement date for the transaction (accordingly, the purchase or borrow must be executed on T+1, T+2, or T+3); (3) the purchase or borrow must be of 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; and (4) the broker-dealer can demonstrate that it has a net flat or net long position in the security on its books and records on the day of the purchase or borrow. The Division staff explained that a broker-dealer may only claim Pre-Fail Credit in the limited circumstances where a *bona fide* purchase or borrow for the entire amount of the fail to deliver is effected by that broker-dealer on a single day that is either T+1, T+2 or T+3, and the broker-dealer can demonstrate on its books and records that it has a net flat or net long position on such day.²⁴ Further, footnote 81 of the Rule 204 Adopting Release provides that, in determining the amount of its close-out obligation, a Participant may rely on its net delivery obligation as reflected in its notification from the 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 (i.e., T+4 or T+6).²⁵

²³ The Firm’s records will include communications with the AP or the covered ETF, if applicable, and any action taken to address a pattern of failure to complete Irrevocable Creation Orders by the AP or the covered ETF.

²⁴ See Multi-Day Close-Out Credit Letter at 2.

²⁵ See Rule 204 Adopting Release, 74 FR at 38272 n.81.

In the Multi-Day Close-Out Credit Letter, the Division staff allowed a Participant or an Allocated Broker-Dealer to claim Credit for closing-out a fail to deliver position prior to the applicable close-out date²⁶ based on net purchases over multiple days (the “Multi-Day Approach”).²⁷

Latour believes that shares of a covered ETF purchased through executed Creation Orders or shares of a covered ETF sold through executed Redemption Orders should be treated in the same manner as purchases or sales of the ETF shares in the secondary market when calculating Credit under the Multi-Day Approach. Accordingly, Latour is seeking confirmation, consistent with the Multi-Day Close-Out Credit Letter, that the Firm would be permitted to count the shares of a covered ETF purchased through executed Creation Orders over multiple days from T+1 to T+5 as Credit toward satisfying the Firm’s close-out obligations under Rule 204 on T+4 or T+6, as applicable, for any day the Firm can demonstrate on its books and records that it had net purchases, calculated based on the entirety of its *bona-fide* trading activity, including its executed Creation Orders and Redemption Orders. Credits aggregated over multiple days from T+1 through T+5, as applicable, would be included in determining the quantity of securities that must be purchased or borrowed to close-out the fail to deliver position on the applicable close-

²⁶ The term “Credit” includes “Pre-Fail Credit” and “Post-Fail Credit” with “Post-Fail Credit” to mean full or partial credit for closing-out a fail to deliver prior to T+6 based on net purchases aggregated over multiple days from T+1 through T+5.

²⁷ See Multi-Day Close-Out Credit Letter at 3-5. The conditions set forth in the Multi-Day Close-Out Credit Letter include [note: capitalized terms in this footnote are used as defined in the Multi-Day Close-Out Credit Letter only and are not otherwise applicable in this letter]: (1) The Multi-Day Approach would not apply to the requirements to satisfy a close-out obligation on the applicable close-out date (i.e., T+4 or T+6), except to the extent that the amount of the close-out obligation to be met on the applicable close-out date could be reduced by claiming Credit using the Multi-Day Approach based on net purchases no later than the applicable close-out date; (2) Credit would only be claimed for days on which the Broker-Dealer can demonstrate on its books and records that it has net purchases for the day, calculated based on the entirety of the Broker-Dealer’s *bona fide* trading activity, and in no case would a Broker-Dealer claim Credit for purchases on a day on which its trading activity results in a net sale position, regardless of whether sales executed on that day had a legitimate economic purpose; (3) the Multi-Day Approach would be applied in a manner that avoids double-counting net purchases, or purchases for compliance with a close-out date (i.e., T+4 or T+6) requirement; (4) a Participant using Attribution with the Multi-Day Approach would reasonably Attribute fails to deliver to each Correspondent using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Correspondent; (5) the same reasonableness standard applicable to Attribution under the Multi-Day Approach would apply to Allocation under the Multi-Day Approach; (6) when calculating the net purchase amount, purchase and sale transactions occurring as a result of options exercises would be recognized on the day exercised, and purchase and sale transactions occurring as a result of options assignments would be recognized on the business day after exercise; (7) Broker-Dealers using the Multi-Day Approach would have supervisory systems in place to ensure that their processes are consistent with the Multi-Day Approach as described in the September 6, 2013 letter requesting no-action relief and would establish, maintain and enforce written policies and procedures reasonably designed to achieve and surveil for compliance with their Rule 204 close-out obligations using the Multi-Day Approach; and (8) Broker-Dealers using the Multi-Day Approach would also make and keep accurate books and records as required by the federal securities laws, including promptly providing such records to the Commission or an SRO upon request in the manner and form agreed to between the staff of the Commission and the Broker-Dealer or between the staff of the SRO and the Broker-Dealer, as applicable.

out date consistent with, and subject to, the requirements set forth in the Multi-Day Close-Out Credit Letter.

Under this approach, the Firm would include covered ETF shares purchased through a Creation Order and ETF shares sold through a Redemption Order as purchase and sale transactions, respectively, when calculating its Credits on T+1 through T+5, as applicable, subject to the representations of this letter and subject to the terms of the Multi-Day Close-Out Credit Letter (the "ETF Creation Multi-Day Approach").²⁸

Policy Discussion

As discussed above, allowing the Firm to use the ETF Creation Approach is consistent with the policy of enforcing the strict close-out requirements of Rule 204 as it requires the Firm to take affirmative action and irrevocably commit itself to purchase the covered ETF shares within the timeframes set forth in Rule 204(a).

The use of the ETF Creation Approach also has the benefit of limiting market impact on the price of the covered ETF shares as an ETF creation has a limited impact on trading in the open market.²⁹ The Commission has recognized commenters' concerns that market impact may be caused by purchase orders executed at the opening of regular trading hours,³⁰ and has permitted the use of certain types of irrevocable VWAP orders to satisfy a Rule 204 close-out obligation subject to certain conditions.³¹

Under the ETF Creation Approach, the use of an Irrevocable Creation Order to close-out a fail to deliver position under Rule 204 is akin to such an irrevocable VWAP order in that both orders:

- Reduce market impact that may occur by executing purchases or borrowings of securities no later than the beginning of regular trading hours;
- Ensure that the Firm has taken an affirmative action and is irrevocably committed to purchasing the securities no later than the beginning of regular trading hours; and
- Resolve the underlying fail to deliver position.

²⁸ This would be limited to T+1 to T+3 if the fail to deliver resulted from a short sale that cannot be attributed to *bona fide* market making activities.

²⁹ This would be of particular benefit if the covered ETF is experiencing unusual market volatility – particularly at the market open.

³⁰ See Rule 204 Adopting Release, 74 FR at 38269-38270.

³¹ These VWAP orders must meet the requirements in footnote 66 of the Rule 204 Adopting Release, 74 FR 38271 n.66.

Permitting Irrevocable Creation Orders to qualify as close-out purchases is consistent with the Commission's goal of reducing fails to deliver because purchases of covered ETF shares in that manner will reduce the applicable Participant's fail to deliver position at the relevant clearing agency.

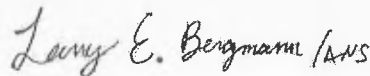
Finally, confirming the use of the ETF Creation Multi-Day Approach for purposes of the Multi-Day Close-Out Credit Letter furthers the Commission's purpose in adopting Rule 204(e) of encouraging broker-dealers to close-out fails to deliver prior to the applicable close-out date.³² Thus, confirming the use of the ETF Creation Multi-Day Approach is consistent with the Commission's policy goal of encouraging more timely resolution of fails to deliver.³³

Conclusion

We respectfully submit that, consistent with the process outlined above, the proposed no-action relief and confirmation of the use of the ETF Creation Multi-Day Approach for purposes of the Multi-Day Close-Out Credit Letter is consistent with the central goals of Rule 204 to reduce fails to deliver and address potentially abusive "naked" short selling. Accordingly, based on the foregoing, we respectfully request that the Division staff provide the requested assurances and confirmation.

If you have any questions, or wish to discuss this matter further, please feel free to call me at 202-661-7032.

Sincerely yours,



Larry E. Bergmann

cc: Leonard J. Amoruso
Matthew B. Comstock
Andrea Orr, Esq.
Valerie Dahiya, Esq.

³² See Rule 204 Adopting Release, 74 FR at 38276.

³³ See *id.* at 38287.