

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR PART 242**

**[Release No. 34-58773; File No. S7-30-08]**

**RIN 3235-AK22**

**Amendments to Regulation SHO**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Interim final temporary rule; request for comments.

**SUMMARY:** The Securities and Exchange Commission (“Commission”) is adopting an interim final temporary rule under the Securities Exchange Act of 1934 (“Exchange Act”) to address abusive “naked” short selling in all equity securities by requiring that participants of a clearing agency registered with the Commission deliver securities by settlement date, or if the participants have not delivered shares by settlement date, immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position. Failure to comply with the close-out requirement of the temporary rule is a violation of the temporary rule. In addition, a participant that does not comply with this close-out requirement, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security either for itself or for the account of another, unless it has previously arranged to borrow or borrowed the security, until the fail to deliver position is closed out.

**DATES:** Effective Date: October 17, 2008 except §242.204T is effective October 17, 2008 until July 31, 2009.

Comment Date: Comments should be received on or before December 16, 2008.

**ADDRESSES:** Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/final.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-30-08 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-30-08. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/final.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** James A. Brigagliano, Associate Director, Josephine J. Tao, Assistant Director, Victoria L. Crane, Branch Chief, Joan M. Collopy, Special

Counsel, Christina M. Adams and Matthew Sparkes, Staff Attorneys, Office of Trading Practices and Processing, Division of Trading and Markets, at (202) 551-5720, at the Commission, 100 F Street, NE, Washington, DC 20549-6628.

**SUPPLEMENTARY INFORMATION:** We are adopting temporary Rule 204T of Regulation SHO [17 CFR 242.204T] as an interim final temporary rule. We are soliciting comments on all aspects of the rule. We will carefully consider the comments that we receive and intend to respond to them in a subsequent release.

## **I. Introduction**

Recently, we have become concerned that there is a substantial threat of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets that could threaten fair and orderly markets. These concerns with respect to financial institutions are evidenced by our recent publication of emergency orders under Section 12(k) of the Exchange Act in July (the “July Emergency Order”)<sup>1</sup> and September of this year (the “Short Sale Ban Emergency Order”).<sup>2</sup> In these orders we noted our concerns about the possible use of unfounded rumors regarding the stability of financial institutions by short sellers for the purpose of manipulating the prices of securities issued by the financial institutions to increase profits through “naked” short selling.<sup>3</sup>

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<sup>1</sup> See Exchange Act Release No. 58166 (July 15, 2008), 73 FR 42379 (July 21, 2008) (imposing borrowing and delivery requirements on short sales of the equity securities of certain financial institutions).

<sup>2</sup> See Exchange Act Release No. 58592 (Sept. 18, 2008), 73 FR 55169 (Sept. 24, 2008) (temporarily prohibiting short selling in the publicly traded securities of certain financial institutions); see also Exchange Act Release No. 58611 (Sept. 21, 2008), 73 FR 55556 (Sept. 25, 2008) (amending the Short Sale Ban Emergency Order).

<sup>3</sup> “Naked” short selling generally refers to selling short without having borrowed the securities to make delivery. See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008, 48009 n.10 (Aug. 6, 2004) (“2004 Regulation SHO Adopting Release”); see also Commission press release, dated July 13, 2008, announcing that the Commission’s Office of Compliance Inspections and Examinations, as well as the Financial Industry Regulatory Authority (“FINRA”) and New York Stock Exchange Regulation, Inc., (“NYSE”) will immediately conduct examinations aimed at the prevention of the intentional spreading of false information intended to manipulate securities prices. See <http://www.sec.gov/news/press/2008/2008-140.htm>. In addition, in April of

Our concerns, however, are not limited to just the financial institutions that were the subject of the July Emergency Order and the Short Sale Ban Emergency Order. Given the importance of confidence in our financial markets as a whole, we have become concerned about sudden and unexplained declines in the prices of equity securities generally. Such price declines can give rise to questions about the underlying financial condition of an institution, which in turn can create a crisis of confidence even without a fundamental underlying basis. This crisis of confidence can impair the liquidity and ultimate viability of an institution, with potentially broad market consequences. These concerns resulted in our issuance on September 17 of this year of an emergency order under Section 12(k) of the Exchange Act (the “September Emergency Order”).<sup>4</sup> Pursuant to that emergency order we imposed enhanced delivery requirements on sales of all equity securities by adding and making immediately effective a temporary rule to Regulation SHO, Rule 204T.<sup>5</sup>

To further our goal of preventing substantial disruption in the securities markets, we are adopting Rule 204T as an interim final temporary rule, with some modifications to address operational and technical concerns resulting from the requirements of the temporary rule as adopted in the September Emergency Order. We intend that the temporary rule will address potentially abusive “naked” short selling by requiring that securities be purchased or borrowed to close out any fail to deliver position in an equity security by no later than the beginning of

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this year, the Commission charged Paul S. Berliner, a trader, with securities fraud and market manipulation for intentionally disseminating a false rumor concerning The Blackstone Group's acquisition of Alliance Data Systems Corp (“ADS”). The Commission alleged that this false rumor caused the price of ADS stock to plummet, and that Berliner profited by short selling ADS stock and covering those sales as the false rumor caused the price of ADS stock to fall. See <http://www.sec.gov/litigation/litreleases/2008/lr20537.htm>.

<sup>4</sup> See Exchange Act Release No. 58572 (Sept. 17, 2008), 73 FR 54875 (Sept. 23, 2008).

<sup>5</sup> See *id.* The September Emergency Order also made immediately effective amendments to Rule 203(b)(3) of Regulation SHO that eliminate the options market maker exception from Regulation SHO's close-out requirement. It also made immediately effective Rule 10b-21, a “naked” short selling antifraud rule.

regular trading hours on the settlement day following the date on which the fail to deliver position occurred. This temporary rule should provide a powerful disincentive to those who might otherwise engage in potentially abusive “naked” short selling.

## II. Background

Short selling involves a sale of a security that the seller does not own or a sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.<sup>6</sup> Short sales normally are settled by the delivery of a security borrowed by or on behalf of the seller. In a “naked” short sale, however, the short seller does not borrow securities in time to make delivery to the buyer within the standard three-day settlement period.<sup>7</sup> As a result, the seller fails to deliver securities to the buyer when delivery is due (known as a “fail” or “fail to deliver”).<sup>8</sup> Sellers sometimes intentionally fail to deliver securities as part of a scheme to manipulate the price of a security,<sup>9</sup> or possibly to avoid borrowing costs associated with short sales, especially when the costs of borrowing stock are high.

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<sup>6</sup> 17 CFR 242.200(a).

<sup>7</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48009 n.10.

<sup>8</sup> Generally, investors complete or settle their security transactions within three settlement days. This settlement cycle is known as T+3 (or “trade date plus three days”). T+3 means that when a trade occurs, the participants to the trade deliver and pay for the security at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange those funds for the securities on that third settlement day. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options settle on the next settlement day following the trade (or T+1). In addition, Rule 15c6-1 prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction. 17 CFR 240.15c6-1; Exchange Act Release No. 33023 (Oct. 7, 1993), 58 FR 52891 (Oct. 13, 1993). However, failure to deliver securities on T+3 does not violate Rule 15c6-1; see also Exchange Act Release No. 56212 (Aug. 7, 2007), 72 FR 45544, n. 2 (Aug. 14, 2007) (“2007 Regulation SHO Final Amendments”).

<sup>9</sup> In 2003, the Commission settled a case against certain parties relating to allegations of manipulative short selling in the stock of a corporation. The Commission alleged that the defendants profited from engaging in massive “naked” short selling that flooded the market with the stock, and depressed its price. See Rhino Advisors, Inc. and Thomas Badian, Lit. Rel. No. 18003 (Feb. 27, 2003); see also SEC v. Rhino Advisors, Inc. and Thomas Badian, Civ. Action No. 03 civ 1310 (RO) (S.D.N.Y.); see also Exchange Act Release No. 48709

Although the majority of trades settle within the standard three-day settlement cycle (“T+3”),<sup>10</sup> we adopted Regulation SHO<sup>11</sup> on July 28, 2004, in part to address problems associated with persistent fails to deliver securities and potentially abusive “naked” short selling. For example, Regulation SHO requires broker-dealers to “locate” securities that the broker-dealer reasonably believes can be delivered within the standard three-day settlement period.<sup>12</sup>

Another requirement of Regulation SHO aimed at potentially abusive “naked” short selling and reducing fails to deliver in certain equity securities is the rule’s “close-out” requirement. Specifically, Rule 203(b)(3) requires participants<sup>13</sup> of a registered clearing agency,<sup>14</sup> which includes broker-dealers, to purchase shares to close out fails to deliver in

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(Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (“2003 Regulation SHO Proposing Release”) (describing the alleged activity in the case involving stock of Sedona Corporation); 2004 Regulation SHO Adopting Release, 69 FR at 48016, n.76.

<sup>10</sup> According to the National Securities Clearing Corporation (“NSCC”), 99% (by dollar value) of all trades settle within T+3. Thus, on an average day, approximately 1% (by dollar value) of all trades, including equity, debt, and municipal securities fail to settle on time.

<sup>11</sup> 17 CFR 242.200. Regulation SHO became effective on January 3, 2005.

<sup>12</sup> 17 CFR 242.203(b)(1). Rule 203(b)(1) of Regulation SHO requires that, “A broker or dealer may not accept a short sale order in an equity security from another person, or effect a short sale in an equity security for its own account, unless the broker or dealer has: (i) Borrowed the security, or entered into a bona-fide arrangement to borrow the security; or (ii) Reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due; and (iii) Documented compliance with this paragraph (b)(1).” This is known as the “locate” requirement. Market makers engaged in bona fide market making in the security at the time they effect the short sale are excepted from this requirement.

<sup>13</sup> For purposes of Regulation SHO, the term “participant” has the same meaning as in section 3(a)(24) of the Exchange Act. See 15 U.S.C. 78c(a)(24).

<sup>14</sup> The term “registered clearing agency” means a clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, that is registered as such pursuant to Section 17A of the Exchange Act. See 15 U.S.C. 78c(a)(23)(A) and 78q-1, respectively; see also 2004 Regulation SHO Adopting Release, 69 FR at 48031. The majority of equity trades in the United States are cleared and settled through systems administered by clearing agencies registered with the Commission. The National Securities Clearing Corporation (“NSCC”) clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter market. NSCC clears and settles trades through the Continuous Net Settlement (“CNS”) system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. In addition, NSCC guarantees the completion of all transactions and interposes itself as the counterparty to both sides of the transaction.

securities with large and persistent fails to deliver, i.e., “threshold securities.”<sup>15</sup> Until the position is closed out, the participant responsible for the fail to deliver position and any broker-dealer from which it receives trades for clearance and settlement may not effect further short sales in that threshold security without first borrowing or arranging to borrow the securities.<sup>16</sup>

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

Due to our concerns about the potentially negative market impact of large and persistent fails to deliver, and the fact that we continued to observe threshold securities with fail to deliver positions that are not being closed out under existing delivery and settlement requirements, effective on October 15, 2007, we adopted an amendment to Regulation SHO that eliminated the “grandfather” exception to Regulation SHO’s close-out requirement.<sup>17</sup>

The options market maker exception excepted any fail to deliver position in a threshold security resulting from short sales effected by a registered options market maker to establish or maintain a hedge on options positions that were created before the underlying security became a

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

<sup>16</sup> See 17 CFR 242.203(b)(3)(iv).

<sup>17</sup> See 2007 Regulation SHO Final Amendments, 72 FR 45544. This amendment also contained a one-time phase-in period that provided that previously-grandfathered fails to deliver in a security that was a threshold security on the effective date of the amendment must be closed out within 35 consecutive settlement days from the effective date of the amendment. The phase-in period ended on December 5, 2007.

threshold security. On September 17, 2008, as part of the September Emergency Order, we adopted and made immediately effective an amendment to Rule 203(b)(3) of Regulation SHO to eliminate the options market maker exception to the rule's close-out requirement.<sup>18</sup> Following the issuance of the September Emergency Order, we adopted amendments making permanent the elimination of the options market maker exception.<sup>19</sup> As we discussed in the 2008 Regulation SHO Final Amendments, we believe it was appropriate to eliminate the options market maker exception in part because substantial levels of fails to deliver continue to persist in threshold securities and it appears that a significant number of these fails to deliver are as a result of the options market maker exception.<sup>20</sup>

In addition to the actions we have taken aimed at reducing fails to deliver and addressing potentially abusive "naked" short selling in threshold securities, we have also taken action targeting potentially abusive "naked" short selling in both threshold and non-threshold securities. For example, in the September Emergency Order we adopted and made immediately effective a "naked" short selling anti-fraud rule, Rule 10b-21, aimed at sellers, including broker-dealers acting for their own accounts, who deceive certain specified persons about their intention or ability to deliver securities in time for settlement and that fail to deliver securities by settlement

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<sup>18</sup> See September Emergency Order, supra note 4.

<sup>19</sup> See Exchange Act Release No. 58775 (Oct. 14, 2008) (adopting final amendments to Rule 203(b)(3) of Regulation SHO to eliminate the options market maker exception from the rule's close-out requirement) ("2008 Regulation SHO Final Amendments"); see also Exchange Act Release No. 56213 (Aug. 7, 2007), 72 FR 45558 (Aug. 14, 2007) ("2007 Regulation SHO Proposed Amendments"); Exchange Act Release No. 54154 (July 14, 2006), 71 FR 41710 (July 21, 2006) ("2006 Regulation SHO Proposed Amendments"); Exchange Act Release No. 58107 (July 7, 2008), 73 FR 40201 (July 14, 2008) ("2008 Regulation SHO Re-Opening Release").

<sup>20</sup> See 2008 Regulation SHO Final Amendments, supra note 19; see also 2008 Regulation SHO Re-Opening Release, 73 FR 40201.



date.<sup>21</sup> Following the issuance of the September Emergency Order, we adopted final amendments making Rule 10b-21 permanent.<sup>22</sup>

Also, as mentioned above, in the July Emergency Order and the Short Sale Ban Emergency Order, we took emergency action targeting “naked” short selling in the securities of certain financial firms that included non-threshold securities. Specifically, on July 15, 2008, we published the July Emergency Order<sup>23</sup> that temporarily imposed enhanced requirements on short sales in the publicly traded securities of certain substantial financial firms. The July Emergency Order required that, in connection with transactions in the publicly traded securities of the substantial financial firms identified in Appendix A to the Emergency Order (“Appendix A Securities”), no person could effect a short sale in the Appendix A Securities using the means or instrumentalities of interstate commerce unless such person or its agent had borrowed, or arranged to borrow, the security or otherwise had the security available to borrow in its inventory, prior to effecting such short sale. The July Emergency Order also required that the short seller deliver the security on settlement date, prohibiting any fails to deliver in the Appendix A Securities.<sup>24</sup>

We issued the July Emergency Order because we were concerned that false rumors regarding financial institutions of significance in the U.S. may have fueled market volatility in the securities of some of these institutions. As we noted in the July Emergency Order, false rumors can lead to a loss of confidence in our markets. Such loss of confidence can lead to panic

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<sup>21</sup> See September Emergency Order, supra note 4.

<sup>22</sup> See Exchange Act Release No. 58774 (Oct. 14, 2008) (“Anti-Fraud Rule Adopting Release”); see also Exchange Act Release No. 57511 (March 17, 2008), 73 FR 15376 (March 21, 2008) (“Anti-Fraud Rule Proposing Release”).

<sup>23</sup> See supra note 1.

<sup>24</sup> See id.

selling, which may be further exacerbated by “naked” short selling. As a result, the prices of securities may artificially and unnecessarily decline below the price level that would have resulted from the normal price discovery process. If significant financial institutions are involved, this chain of events can threaten disruption of our markets.<sup>25</sup>

On July 29, 2008, we extended the July Emergency Order after carefully reevaluating the current state of the markets in consultation with officials of the Board of Governors of the Federal Reserve System, the Department of the Treasury, and the Federal Reserve Bank of New York and remaining concerned about the ongoing threat of market disruption and effects on investor confidence.<sup>26</sup> Pursuant to the extension, the July Emergency Order terminated at 11:59 p.m. EDT on August 12, 2008.

Due to our continued concerns regarding recent market conditions and that short selling in the securities of a wider range of financial institutions than those subject to the July Emergency Order may be causing sudden and excessive fluctuations of the prices of such securities that could threaten fair and orderly markets, on September 18, 2008, we issued the Short Sale Ban Emergency Order.<sup>27</sup> The Short Sale Ban Emergency Order temporarily prohibited any person from effecting a short sale in the publicly traded securities of certain financial institutions. On October 2, 2008, we extended the Short Sale Ban Emergency Order due to our continued concerns regarding the ongoing threat of market disruption and investor

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<sup>25</sup> We delayed the effective date of the July Emergency Order to July 21, 2008 to create the opportunity to address, and to allow sufficient time for market participants to make, adjustments to their operations to implement the enhanced requirements. Moreover, in addressing anticipated operational accommodations necessary for implementation of the July Emergency Order, we issued an amendment to the July Emergency Order on July 18, 2008. See Exchange Act Release No. 58190 (July 18, 2008) (excepting from the July Emergency Order bona fide market makers, short sales in Appendix A Securities sold pursuant to Rule 144 of the Securities Act of 1933, and certain short sales by underwriters, or members of a syndicate or group participating in distributions of Appendix A Securities).

<sup>26</sup> See Exchange Act Release No. 58248 (July 29, 2008), 73 FR 45257 (Aug. 4, 2008).

<sup>27</sup> See supra note 2.

confidence in the financial markets.<sup>28</sup> Pursuant to the extension, the Short Sale Ban Emergency Order terminated at 11:59 p.m. EDT on October 8, 2008.

Our concerns are no longer limited to just the financial institutions that were the subject of the July Emergency Order and the Short Sale Ban Emergency Order. Given the importance of confidence in our financial markets as a whole, we have become concerned about sudden and unexplained declines in the prices of equity securities generally. These concerns resulted in our adopting and making immediately effective in the September Emergency Order the enhanced delivery requirements contained in temporary Rule 204T.<sup>29</sup> For the reasons explained in detail herein, today we are adopting the temporary rule as set forth in the September Emergency Order, with modifications to address technical and operational concerns resulting from the requirements of the temporary rule.

### **III. Concerns about “Naked” Short Selling**

We have been concerned about “naked” short selling and, in particular, abusive “naked” short selling, for some time. As discussed above, such concerns were a primary reason for our adoption of Regulation SHO in 2004, the elimination of the “grandfather” and options market maker exceptions to Regulation SHO’s close-out requirement, the adoption of a “naked” short selling antifraud rule, and our recent issuance of the July Emergency Order, Short Sale Ban Emergency Order, and the September Emergency Order.

Despite these Commission actions, due to our continuing concerns about the potential impact of “naked” short selling on the weakened financial markets, we believe it is necessary to

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<sup>28</sup> See Exchange Act Release No. 58723 (Oct. 2, 2008) (stating that the Short Sale Ban Emergency Order would terminate the earlier of (i) three business days from the President’s signing of the Emergency Economic Stabilization Act of 2008 (H.R. 1424), or (ii) 11:59 p.m. E.D.T. on Friday, October 17, 2008).

<sup>29</sup> See September Emergency Order, supra note 4.

immediately adopt as an interim final temporary rule, temporary rule 204T, with some modifications to address technical and operational concerns resulting from the rule's requirements as set forth in the September Emergency Order. We believe that adoption of temporary rule 204T as an interim final temporary rule is necessary to further address abusive "naked" short selling and, therefore, fails to deliver resulting from such short sales, in all equity securities. As we have stated on several prior occasions, we believe that all sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased.<sup>30</sup> In addition, as we have stated on several prior occasions, we are concerned about the negative effect that fails to deliver may have on the markets and shareholders.<sup>31</sup>

For example, large and persistent fails to deliver may deprive shareholders of the benefits of ownership, such as voting and lending.<sup>32</sup> In addition, where a seller of securities fails to deliver securities on settlement date, in effect the seller unilaterally converts a securities contract (which is expected to settle within the standard three-day settlement period) into an undated futures-type contract, to which the buyer might not have agreed, or that might have been priced differently.<sup>33</sup> Moreover, sellers that fail to deliver securities on settlement date may attempt to use this additional freedom to engage in trading activities to improperly depress the price of a security. For example, by not borrowing securities and, therefore, not making delivery within the standard three-day settlement period, the seller does not incur the costs of borrowing.

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<sup>30</sup> See, e.g., Anti-Fraud Rule Proposing Release, 73 FR at 15376.

<sup>31</sup> See, e.g., 2007 Regulation SHO Final Amendments, 72 FR at 45544; 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; 2007 Regulation SHO Proposed Amendments, 72 FR at 45558-45559; Anti-Fraud Rule Proposing Release, 73 FR at 15378.

<sup>32</sup> See id.

<sup>33</sup> See id.

In addition, issuers and investors have repeatedly expressed concerns about fails to deliver in connection with manipulative “naked” short selling. For example, in response to proposed amendments to Regulation SHO in 2006<sup>34</sup> designed to further reduce the number of persistent fails to deliver in certain equity securities by eliminating Regulation SHO’s “grandfather” exception, and limiting the duration of the rule’s options market maker exception, we received a number of comments that expressed concerns about “naked” short selling and extended delivery failures.<sup>35</sup> Commenters continued to express these concerns in response to proposed amendments to eliminate the options market maker exception to the close-out requirement of Regulation SHO in 2007.<sup>36</sup>

To the extent that fails to deliver might be part of manipulative “naked” short selling, which could be used as a tool to drive down a company’s stock price,<sup>37</sup> such fails to deliver may undermine the confidence of investors.<sup>38</sup> These investors, in turn, may be reluctant to commit

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<sup>34</sup> See 2006 Regulation SHO Proposed Amendments, 71 FR 41710.

<sup>35</sup> See, e.g., letter from Patrick M. Byrne, Chairman and Chief Executive Officer, Overstock.com, Inc., dated Sept. 11, 2006; letter from Daniel Behrendt, Chief Financial Officer, and Douglas Klint, General Counsel, TASER International, dated Sept. 18, 2006; letter from John Royce, dated April 30, 2007; letter from Michael Read, dated April 29, 2007; letter from Robert DeVivo, dated April 26, 2007; letter from Ahmed Akhtar, dated April 26, 2007.

<sup>36</sup> See, e.g., letter from Jack M. Wedam, dated Oct. 16, 2007; letter from Michael J. Ryan, Executive Director and Senior Vice President, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated Sept. 13, 2007 (“U.S. Chamber of Commerce”); letter from Robert W. Raybould, CEO Enteleke Capital Corp., dated Sept. 12, 2007 (“Raybould”); letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 11, 2007 (“NCANS”).

<sup>37</sup> See supra note 9 (discussing a case in which we alleged that the defendants profited from engaging in massive “naked” short selling that flooded the market with the company’s stock, and depressed its price); see also S.E.C. v. Gardiner, 48 S.E.C. Docket 811, No. 91 Civ. 2091 (S.D.N.Y. March 27, 1991) (alleged manipulation by sales representative by directing or inducing customers to sell stock short in order to depress its price); U.S. v. Russo, 74 F.3d 1383, 1392 (2d Cir. 1996) (short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Exchange Act Section 10(b) and Rule 10b-5).

<sup>38</sup> In response to the 2007 Regulation SHO Proposed Amendments, we received comment letters discussing the impact of fails to deliver on investor confidence. See, e.g., letter from NCANS. Commenters expressed similar concerns in response to the 2006 Regulation SHO Proposed Amendments. See, e.g., letter from Mary Helburn, Executive Director, National Coalition Against Naked Shorting, dated Sept. 30, 2006 (“NCANS (2006)”); letter from Richard Blumenthal, Attorney General, State of Connecticut, dated Sept. 19, 2006 (“Blumenthal”).

capital to an issuer they believe to be subject to such manipulative conduct.<sup>39</sup> In addition, issuers may believe that they have suffered unwarranted reputational damage due to investors' negative perceptions regarding fails to deliver in the issuer's security.<sup>40</sup> Unwarranted reputational damage caused by fails to deliver might have an adverse impact on the security's price.<sup>41</sup>

#### **IV. Discussion of Temporary Rule 204T**

##### **A. Rule 204T's Close-Out Requirement**

In these unusual and extraordinary times and in an effort to prevent substantial disruption to the securities markets, we have concluded that it is necessary to immediately adopt as an interim final temporary rule, temporary rule Rule 204T, with some modifications to address technical and operational concerns resulting from the rule's requirements as set forth in the

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<sup>39</sup> In response to the 2007 Regulation SHO Proposed Amendments, we received comment letters expressing concern about the impact of potential "naked" short selling on capital formation, claiming that "naked" short selling causes a drop in an issuer's stock price and may limit the issuer's ability to access the capital markets. See, e.g., letter from Robert K. Lifton, Chairman and CEO, Medis Technologies, Inc., dated Sept. 12, 2007 ("Medis"); letter from NCANS. Commenters expressed similar concerns in response to the 2006 Regulation SHO Proposed Amendments. See, e.g., letter from Congressman Tom Feeney - Florida, U.S. House of Representatives, dated Sept. 25, 2006 ("Feeney"); see also letter from Zix Corporation, dated Sept. 19, 2006 ("Zix") (stating that "[m]any investors attribute the Company's frequent re-appearances on the Regulation SHO list to manipulative short selling and frequently demand that the Company "do something" about the perceived manipulative short selling. This perception that manipulative short selling of the Company's securities is continually occurring has undermined the confidence of many of the Company's investors in the integrity of the market for the Company's securities.").

<sup>40</sup> Due in part to such concerns, some issuers have taken actions to attempt to make transfer of their securities "custody only," (i.e., certificating the securities and prohibiting ownership by a securities intermediary) thus preventing transfer of their stock to or from securities intermediaries such as the Depository Trust Company ("DTC") or broker-dealers. See Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, at 62975 (Nov. 6, 2003). Some issuers have attempted to withdraw their issued securities on deposit at DTC in order to make the securities ineligible for book-entry transfer at a securities depository. See id. Withdrawing securities from DTC or requiring custody-only transfers would undermine the goal of a national clearance and settlement system designed to reduce the physical movement of certificates in the trading markets. See id. We note, however, that in 2003 the Commission approved a DTC rule change clarifying that its rules provide that only its participants may withdraw securities from their accounts at DTC, and establishing a procedure to process issuer withdrawal requests. See Exchange Act Release No. 47978 (June 4, 2003), 68 FR 35037 (June 11, 2003).

<sup>41</sup> See 2006 Regulation SHO Proposed Amendments, 71 FR at 41712; 2007 Regulation SHO Amendments, 72 FR at 45544; 2007 Regulation SHO Proposed Amendments, 72 FR at 45558-45559; Anti-Fraud Rule Proposing Release, 73 FR at 15378 (providing additional discussion of the impact of fails to deliver on the market); see also Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972, 62975 (Nov. 6, 2003) (discussing the impact of "naked" short selling on the market).

September Emergency Order. We believe that adoption of the temporary rule will substantially restrict the practice of potentially abusive “naked” short selling in all equity securities by strengthening the delivery requirements for such securities.<sup>42</sup>

Specifically, temporary Rule 204T(a) provides that a participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours<sup>43</sup> on the settlement day<sup>44</sup> following the settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.<sup>45</sup>

Temporary Rule 204T(a)’s close-out requirement requires a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency on the settlement date for a transaction to immediately borrow or purchase securities to close out the amount of the fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the settlement date (the “Close-Out Date”). This close-out requirement requires that the participant take affirmative action to purchase or borrow securities. Thus, a participant may not offset the amount of its settlement date fail to deliver position with shares that the

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<sup>42</sup> As noted above, in a “naked” short sale, the short seller does not borrow or arrange to borrow securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due. See supra note 7 and supporting text.

<sup>43</sup> “Regular trading hours” has the same meaning as in Rule 600(b)(64) of Regulation NMS. Rule 600(b)(64) provides that “Regular trading hours means the time between 9:30 a.m. and 4:00 p.m. Eastern Time, or such other time as is set forth in the procedures established pursuant to § 242.605(a)(2).”

<sup>44</sup> The term “settlement day” is defined in Rule 203(c)(5) of Regulation SHO as: “. . . any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.” 17 CFR 242.203(c)(5).

<sup>45</sup> See temporary Rule 204T(a).

participant receives or will receive on the Close-Out Date.<sup>46</sup> To meet its close-out obligation a participant also must be able to demonstrate on its books and records that on the Close-Out Date it purchased or borrowed shares in the full quantity of its settlement date fail to deliver position and, therefore, that the participant has a net flat or net long position on its books and records in that equity security on the Close-Out Date.

The temporary rule defines a “settlement date” as “the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.”<sup>47</sup> This definition is consistent with Rule 15c6-1 that prohibits broker-dealers from effecting or entering into a contract for the purchase or sale of a security that provides for payment of funds and delivery of securities later than the third business day after the date of the contract unless otherwise expressly agreed to by the parties at the time of the transaction.<sup>48</sup>

Because most transactions settle by T+3 and because delivery on all sales should be made by settlement date, participants should consider having in place policies and procedures to help ensure that delivery is being made by settlement date. We intend to examine participants’ policies and procedures to determine whether such policies and procedures monitor for delivery by settlement date.<sup>49</sup>

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<sup>46</sup> In determining its close-out obligation, a participant may rely on its net delivery obligation as reflected in its notification from NSCC regarding its securities delivery and payment obligations, provided such notification is received prior to the beginning of regular trading hours on the Close-Out Date.

<sup>47</sup> See temporary Rule 204T(f)(1).

<sup>48</sup> See 17 CFR 240.15c6-1.

<sup>49</sup> Of course, broker-dealers must comply with any applicable SRO policies and procedures requirements. For example, NASD Rule 3010 contains, among other things, written procedures requirements for member firms.



Similar to the existing close-out requirement of Rule 203(b)(3) of Regulation SHO, the temporary rule is based on a participant's fail to deliver position at a registered clearing agency. As noted above, the NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter markets. NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. Because the temporary rule is based on a participant's fail to deliver position at a registered clearing agency, the temporary rule is consistent with current settlement practices and procedures and with the Regulation SHO framework regarding delivery of securities.<sup>50</sup>

In addition, similar to Rule 203(b)(3)(vi) of Regulation SHO, the temporary rule provides that a participant may reasonably allocate its responsibility to close out a fail to deliver position to another broker-dealer from which the participant receives trades for clearance or settlement.<sup>51</sup> Specifically, temporary Rule 204T(d) provides that if a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or from which it receives trades for settlement, based on such broker's or dealer's short position, the provisions of Rule 204T(a) and (b) relating to such fail to

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<sup>50</sup> See 17 CFR 242.203(b)(3) (Regulation SHO's close-out requirement). Consistent with current industry practice under Regulation SHO, with respect to a net syndicate short position created in connection with a distribution of a security that is part of a fail to deliver position at a registered clearing agency, the requirements of temporary Rule 204T shall not apply provided action is taken to close out the net syndicate short position by no later than the beginning of regular trading hours on the thirtieth day after commencement of sales in the distribution. See e.g., Exchange Act Release No. 58190 (July 18, 2008) (amending the July Emergency Order to provide an exception from its requirements for fails to deliver in connection with syndicate offerings).

<sup>51</sup> See 17 CFR 242.203(b)(3)(vi). Rule 203(b)(3)(vi) provides that "[i]f a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this paragraph (b)(3) relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant."

deliver position shall apply to such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.<sup>52</sup>

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

Unlike Rule 203(b)(3)(vi) of Regulation SHO, temporary Rule 204T(d) imposes an additional notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements. Specifically, temporary Rule 204T(d) provides that a broker or dealer that has been allocated a portion of a fail to deliver position that does not comply with the provisions of temporary Rule 204T(a) must immediately notify the participant that it has become subject to the borrowing requirements of temporary Rule 204T(b).<sup>53</sup> We are adopting this notification requirement so that participants will know when a broker-dealer for which they clear and settle trades has become subject to the temporary rule's borrowing requirements.

The temporary rule also differs from the current close-out requirement of Regulation SHO in that it applies to fails to deliver in all equity securities rather than only to those securities with a large and persistent level of fails to deliver, i.e., threshold securities. A primary purpose of the temporary rule is to prevent the use of "naked" short selling as part of a manipulative

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<sup>52</sup> See temporary Rule 204T(d).

<sup>53</sup> See id.

scheme. To achieve this purpose, the rule must apply to all equity securities, regardless of the level or persistence of any fails to deliver in such securities. In addition, as discussed above, we believe that all sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased. We believe this should be the case for sales in all equity securities and are adopting this temporary rule to further that goal.

Regulation SHO, as adopted in 2004, was a first step in trying to reduce persistent fails to deliver and address abusive “naked” short selling. In Regulation SHO, we took a targeted approach, imposing additional delivery requirements on securities with a substantial and persistent amount of fails to deliver. As we stated in the 2004 Regulation SHO Adopting Release, we took this targeted approach at that time in an effort not to burden the vast majority of securities where there are not similar concerns regarding settlement.<sup>54</sup> In addition, Regulation SHO’s close-out requirement was adopted to address potential abuses that may occur with large, extended fails to deliver.<sup>55</sup> We also noted in the 2004 Regulation SHO Adopting Release, however, that we would pay close attention to the operation and efficacy of the provisions we were adopting at that time and would consider whether any further action was warranted.<sup>56</sup>

Because of continued concerns about the potentially negative market impact of fails to deliver, and the fact that through our monitoring of the efficacy of Regulation SHO’s close-out requirement we continued to observe threshold securities with fail to deliver positions that are not being closed out under existing delivery and settlement requirements, we eliminated the

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<sup>54</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48016.

<sup>55</sup> See *id.* at 48017.

<sup>56</sup> See *id.* at 48018.

“grandfather” and options market maker exceptions to Regulation SHO’s close-out requirements.<sup>57</sup>

However, we are concerned that Regulation SHO’s current provisions have not gone far enough in reducing fails to deliver and addressing potentially abusive “naked” short selling.<sup>58</sup> More is needed to reduce fails to deliver and to address potentially abusive “naked” short selling, especially in light of the current instability and lack of investor confidence in the financial markets.<sup>59</sup> In addition, because Regulation SHO’s close-out requirement applies only to threshold securities, fails to deliver in non-threshold securities never have to be closed out.<sup>60</sup> We believe that adoption of temporary rule 204T as an interim final temporary rule is necessary to curtail fails to deliver in both threshold and non-threshold securities to further address abusive “naked” short selling in such securities.

As discussed above, due to our concerns about potentially abusive “naked” short selling in certain non-threshold securities, we recently issued the July Emergency Order to temporarily impose enhanced requirements on short sales in the Appendix A Securities. Following our

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<sup>57</sup> On June 13, 2007, we adopted amendments to eliminate the “grandfather” exception to Regulation SHO’s close-out requirement. On September 17, 2008, in the September Emergency Order, we adopted amendments to eliminate the options market maker exception, which amendments were subsequently made permanent. See supra notes 17, 18 and 19.

<sup>58</sup> See, e.g., 2007 Regulation SHO Final Amendments, 72 FR 45544 (eliminating the “grandfather” exception to Regulation SHO’s close-out requirement due to our observing continued fails to deliver in threshold securities); 2008 Regulation SHO Final Amendments, supra note 19 (eliminating the options market maker exception to Regulation SHO’s close-out requirement due to substantial levels of fails to deliver continuing to persist in optionable threshold securities).

<sup>59</sup> See, e.g., letter from Leland Chan, General Counsel, California Bankers Association, dated Aug. 21, 2008; letter from Eric C. Jensen, Esq., Cooley Godward Kronish L.P., dated Aug. 21, 2008; letter from Steven B. Boehm and Cynthia M. Krus, Sutherland Asbill Brennan LLP, dated July 31, 2008; letter from James J. Angel, Professor of Finance, Georgetown University, McDonough School of Business, dated Aug. 20, 2008; letter from Tuan Nguyen, dated Aug. 8, 2008.

<sup>60</sup> OEA estimates that fails to deliver in non-threshold securities averaged approximately 624 million shares or \$4.6 billion in value per day from January to July 2008. These fails account for approximately 54.5% (56.6%) of all fail to deliver shares (by dollar value).

issuance of the July Emergency Order, we issued the Short Sale Ban Emergency Order in which we took the additional step of prohibiting short selling in the securities of a wider range of financial institutions than those subject to the July Emergency Order. In addition, we issued the September Emergency Order which, in part, imposed enhanced delivery requirements for transactions in all equity securities and made effective immediately a “naked” short selling antifraud rule. We took these emergency actions because we were concerned about panic selling in securities due to a loss of confidence that could be further exacerbated by “naked” short selling.

Following the issuance of the July Emergency Order, members of the public have repeatedly expressed their concerns about a loss of confidence in the financial markets.<sup>61</sup> In addition, since the termination of the July Emergency Order and the issuance of the Short Sale Ban Emergency Order and the September Emergency Order, we have continued our evaluation of the markets and our discussions with the Federal Reserve, Treasury, and the Federal Reserve Bank of New York regarding the state of the financial markets. In light of these processes, we have determined that we must take action to adopt as an interim final temporary rule, temporary Rule 204T, to substantially restrict “naked” short selling in all equity securities. As with the July Emergency Order, the Short Sale Ban Emergency Order, and the September Emergency Order, we are adopting this temporary rule as a preventative step to help restore market confidence.

In addition to applying the temporary rule to fails to deliver in all equity securities, rather than just threshold securities, the temporary rule also differs from the close-out requirement of

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<sup>61</sup> See, e.g., letter from Tom Donohue, President, U.S. Chamber of Commerce, dated July 15, 2008; letter from Ron Heller, dated July 21, 2008; letter from Ronald L. Rourke, dated July 21, 2008; letter from Wayne Jett, Managing Principal and Chief Economist at Classical Capital, LLC, dated July 24, 2008; letter from Edward Herlihy and Theodore Levine, Wachtell, Lipton, Rosen and Katz, LLP, dated Sept. 16, 2008; letter from Sen. Hillary Rodham Clinton, dated Sept. 17, 2008; letter from Representative D. Burton, dated Sept. 18, 2008; letter from Elliott Bossen, Chief Investment Officer at Silverback Asset Management, dated Sept. 24, 2008.

Rule 203(b)(3) of Regulation SHO in that it shortens the close-out period for such fails to deliver.<sup>62</sup> For the reasons discussed below, rather than requiring close out of a fail to deliver position within thirteen consecutive settlement days (or 10 days after settlement date), temporary Rule 204T requires a participant to immediately purchase or borrow shares to close out a fail to deliver position by no later than the beginning of regular trading hours on the settlement day following the day on which the fail to deliver position occurs.

As noted above, trades in most securities generally settle within a three-day settlement cycle, known as T+3 (or "trade date plus three days"). T+3 means that when a trade occurs, the participants to the trade are expected to deliver and pay for the security at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange those funds for the securities on that third business day. The three-day settlement period applies to most security transactions, including stocks, bonds, municipal securities, mutual funds traded through a brokerage firm, and limited partnerships that trade on an exchange. Government securities and stock options typically settle on the next business day following the trade (or T+1).<sup>63</sup> We believe that delivery on all sales should be made by settlement date and, therefore, in temporary Rule 204T we are requiring that fails to deliver in all equity securities be closed out by no later than the beginning of regular trading hours on the Close-Out Date.

In the 2004 Regulation SHO Adopting Release we stated we were adopting a thirteen consecutive settlement day close-out requirement in part because the close-out requirement applied to fails to deliver resulting from long and short sales in threshold securities, and

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<sup>62</sup> Rule 203(b)(3) of Regulation SHO provides: "If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity." See 17 CFR 242.203(b)(3).

<sup>63</sup> See supra note 8.

extending the time period to ten days after settlement date for a transaction would make the close-out requirement consistent with Rule 15c3-3(m).<sup>64</sup> In addition, we noted in that release that ten days after settlement was also the timeframe used at that time in NASD Rule 11830.<sup>65</sup> We also acknowledged that a shorter timeframe, such as two days after settlement, may capture many instances of ordinary course settlement delays.<sup>66</sup>

In addition, we have stated previously that the vast majority of fails to deliver are closed out within five days after T+3.<sup>67</sup> In addition, a recent analysis by our Office of Economic Analysis found that more than half of all fails to deliver and more than 70% of all fail to deliver positions are closed out within two settlement days after T+3.<sup>68</sup> Although this information shows that delivery is being made, it demonstrates that often delivery is not being made until several days following the standard three-day settlement cycle. In addition, the current close-out requirement for threshold securities under Regulation SHO and the lack of any close-out requirement for non-threshold securities under Regulation SHO enables fails to deliver to persist for many days beyond settlement date. We believe that allowing fails to deliver to extend out beyond settlement date for a transaction is too long.

We have continuously monitored the extent of fails to deliver and abusive “naked” short selling in the markets. We believe that allowing fails to deliver in all equity securities to persist

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<sup>64</sup> See 17 CFR 240.15c3-3(m).

<sup>65</sup> See 2004 Regulation SHO Adopting Release, 69 FR at 48017, n.93.

<sup>66</sup> See id.

<sup>67</sup> See, e.g., 2007 Regulation SHO Final Amendments, 72 FR at 45544, n.5.

<sup>68</sup> OEA’s analysis examined the period from January to July 2008 and used the age of the fail to deliver position as reported by the NSCC. The NSCC data included only securities with at least 10,000 shares in fails to deliver. We note that these numbers included securities that were not subject to the close-out requirement in Rule 203(b)(3) of Regulation SHO, which applies only to “threshold securities” as defined in Rule 203(c)(6) of Regulation SHO.

for thirteen consecutive settlement days (10 days after settlement date) if such securities are threshold securities, or indefinitely if such securities are not threshold securities, is too long. As discussed above, fails to deliver may be indicative of a scheme to manipulate the price of a security. In addition, we are concerned about the negative effect that fails to deliver and potentially abusive “naked” short selling may have on the market and the broader economy, including on investor confidence. Temporary Rule 204T addresses these concerns by requiring a participant to immediately close out a fail to deliver position by purchasing or borrowing securities by no later than the beginning of regular trading hours on the Close-Out Date.

We believe we should act to require earlier close out so that more sales settle by settlement date. Indeed, we believe that delivery on all sales should be made by settlement date. As we discuss above, and as we have stated on several prior occasions, we believe that all sellers of securities should promptly deliver, or arrange for delivery of, securities to the respective buyer and all buyers of securities have a right to expect prompt delivery of securities purchased.<sup>69</sup> Although the temporary rule’s close-out requirement may capture some instances of ordinary course settlement delays, we believe that the temporary rule’s close-out requirement is necessary to help ensure that fails to deliver in all equity securities settle by settlement date. In addition, as discussed above, due to our belief that delivery should be made by settlement date, participants should consider having policies and procedures in place to monitor for the delivery of securities by settlement date.

We understand, however, that fails to deliver may occur from long sales within the first two settlement days after settlement date for legitimate reasons. For example, human or mechanical errors or processing delays can result from transferring securities in custodial or

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<sup>69</sup> See supra note 30.



other form rather than book-entry form, thereby causing a fail to deliver on a long sale within the normal three-day settlement period.

Thus, temporary Rule 204T(a)(1) includes an exception from the temporary rule's close-out requirement for fail to deliver positions resulting from long sales of all equity securities. Specifically, temporary Rule 204T(a)(1) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security and the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, the participant shall by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.<sup>70</sup>

## **B. Borrowing Requirements**

If a participant does not purchase or borrow shares, as applicable, to close out a fail to deliver position in accordance with temporary Rule 204T, the participant violates the close-out requirement of the temporary rule. In addition, the temporary rule imposes on the participant for its own trades and on all broker-dealers from which that participant receives trades for clearance and settlement (including introducing and executing brokers), a requirement to borrow or arrange to borrow securities prior to accepting or effecting further short sales in that security.

Specifically, temporary Rule 204T(b) provides that the participant and any broker or dealer from which it receives trades for clearance and settlement, including any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation

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<sup>70</sup> See temporary Rule 204T(a)(1). We note that if a person that has loaned a security to another person sells the security and a bona fide recall of the security is initiated within two business days after trade date, the person that has loaned the security will be "deemed to own" the security for purposes of Rule 200(g)(1) of Regulation SHO, and such sale will not be treated as a short sale for purposes of temporary Rule 204T. In addition, a broker-dealer may mark such orders as "long" sales provided such marking is also in compliance with Rule 200(c) of Regulation SHO. Thus, the close-out requirement of temporary Rule 204T(a)(1) applies to sales of such securities.

SHO,<sup>71</sup> may not accept a short sale order in an equity security from another person, or effect a short sale order in such equity security for its own account, to the extent that the broker or dealer submits its short sales to that participant for clearance and settlement, without first borrowing the security, or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.<sup>72</sup>

The borrow requirements of temporary Rule 204T(b) are consistent with the requirements of Rule 203(b)(3)(iv) of Regulation SHO for a participant that has not closed out a fail to deliver position in a threshold security that has persisted for thirteen consecutive settlement days.<sup>73</sup> Similar to Regulation SHO, the temporary rule is aimed at addressing potentially abusive “naked” short selling. To that end, we believe it is appropriate to include in the temporary rule borrow requirements for broker-dealers, including participants, that sell short a security that has a fail to deliver position that has not been closed out in accordance with the requirements of the temporary rule. We believe that the borrow requirements of temporary Rule 204T(b) will further our goal of limiting fails to deliver and addressing abusive “naked” short selling by promoting the prompt and accurate clearance and settlement of securities transactions. By requiring that participants and broker-dealers from which they receive trades for clearance and settlement

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<sup>71</sup> See 17 CFR 242.203(b)(2)(iii) (providing an exception from Regulation SHO’s “locate” requirement for short sales effected by a market maker in connection with bona fide market making activities in the securities for which the exception is claimed).

<sup>72</sup> See temporary Rule 204T(b).

<sup>73</sup> See 17 CFR 242.203(b)(3)(iv). Rule 203(b)(3)(iv) of Regulation SHO provides that “[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.”

borrow or arrange to borrow securities prior to accepting or effecting short sales in the security that has a fail to deliver position that has not been closed out, the temporary rule will help to ensure that shares will be available for delivery on the short sale by settlement date and, thereby, help to avoid additional fails to deliver occurring in the security.

Unlike the borrow requirements of Rule 203(b)(3)(iv) of Regulation SHO, however, the borrow requirements of the temporary rule specify that participants must notify all broker-dealers from which they receive trades for clearance and settlement that a fail to deliver position has not been closed out in accordance with temporary Rule 204T. Specifically, temporary Rule 204T(c) provides that the participant must notify any broker or dealer from which it receives trades for clearance and settlement, including any market maker that is otherwise entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,<sup>74</sup> (a) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of temporary Rule 204T, and (b) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.<sup>75</sup>

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

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<sup>74</sup> See 17 CFR 203(b)(2)(iii) (providing for an exception from the “locate” requirement for market makers engaged in bona fide market making in that security at the time of the short sale).

<sup>75</sup> See temporary Rule 204T(c).

The temporary rule, however, includes an exception from the borrowing requirements for any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. Specifically, temporary Rule 204T(b)(1) provides that a broker or dealer shall not be subject to the requirements of temporary Rule 204T(b) if the broker or dealer timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that the broker or dealer is in compliance with the requirements of temporary Rule 204T(e).<sup>76</sup> We have included this exception because we do not believe that a broker-dealer should be subject to the borrowing requirements of the temporary rule if the broker-dealer can demonstrate that it did not incur a fail to deliver position in the security on settlement date.

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

### **C. Pre-Fail Credit**

To avoid the borrow or arrangement to borrow requirement of temporary Rule 204T(a), a participant could close-out the fail by borrowing and delivering securities sufficient to close-out

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<sup>76</sup> See temporary Rule 204T(b)(1). Temporary Rule 204T(e) is discussed in detail below in Section IV.C.

the fail to deliver position prior to the beginning of regular trading hours on the Close-Out Date. If, however, the participant does not succeed in eliminating the fail to deliver position the participant can only close out that position by immediately borrowing or purchasing securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the Close-Out Date in accordance with temporary Rule 204T.

To encourage close outs of fail to deliver positions prior to the Close-Out Date, similar to the September Emergency Order,<sup>77</sup> temporary Rule 204T(e) provides that a broker-dealer can satisfy the temporary rule's close-out requirement by purchasing securities in accordance with the conditions of that provision (i.e., broker-dealers will receive "pre-fail credit" for the purchase). Specifically, temporary Rule 204T(e) provides that even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with temporary Rule 204T(a), or has not allocated a fail to deliver position to a broker or dealer in accordance with temporary Rule 204T(d), a broker or dealer shall not be subject to the requirements of paragraphs (a) or (b) of the temporary rule if the broker or dealer purchases securities prior to the beginning of regular trading hours on the Close-Out Date for a long or short sale to close out an open short position, and if:

- (1) The purchase is bona fide;
- (2) The purchase is executed on, or after, trade date but by no later than the end of regular trading hours on settlement date for the transaction;
- (3) The purchase is of a quantity of securities sufficient to cover the entire amount of the open short position; and

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<sup>77</sup> See Exchange Act Release No. 58711 (Oct. 1, 2008) (stating that in connection with extending the September Emergency Order, the Commission incorporates and adopts the Division of Trading and Markets: Guidance Regarding the Commission's Emergency Order Concerning Rules to Protect Investors Against "Naked" Short Selling Abuses and the Division of Trading and Markets Guidance Regarding Sale of Loaned but Recalled Securities).

(4) The broker or dealer can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is seeking to demonstrate that it has purchased shares to close out its open short position.

To receive pre-fail credit under temporary Rule 204T(e), the purchase must be “bona fide.” Thus, where a broker-dealer enters into an arrangement with another person to purchase 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 will not be considered to be “bona fide.”<sup>78</sup> In addition, the purchase must be of a quantity of securities sufficient to cover the entire amount of the open short position.<sup>79</sup>

Temporary Rule 204T(e) also requires that to receive pre-fail credit, the purchase must be executed on, or after, trade date but by no later than the end of regular trading hours on the settlement date of the transaction that resulted in the fail to deliver position at a registered clearing agency.<sup>80</sup> The purpose of this provision is to encourage broker-dealers to close out fail to deliver positions prior to the beginning of regular trading hours on the Close-Out Date.

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<sup>78</sup> See 17 CFR 203(b)(3)(vii) (discussing bona fide purchases for purposes of Regulation SHO). It is possible under Regulation SHO that a close out by a participant of a registered clearing agency may result in a fail to deliver position at another participant if the counterparty from which the participant purchases securities fails to deliver. However, Regulation SHO prohibits a participant of a registered clearing agency, or a broker-dealer for which it clears transactions, from engaging in “sham close outs” by entering into an arrangement with a counterparty to purchase securities for purposes of closing out a fail to deliver position and the purchaser knows or has reason to know that the counterparty will not deliver the securities, and which thus creates another fail to deliver position. See *id.* at (b)(3)(vii); 2004 Regulation SHO Adopting Release, 69 FR at 48018 n.96. In addition, we note that borrowing securities, or otherwise entering into an arrangement with another person to create the appearance of a purchase would not satisfy the close-out requirement of Regulation SHO. For example, the purchase of paired positions of stock and options that are designed to create the appearance of a bona fide purchase of securities but that are nothing more than a temporary stock lending arrangement would not satisfy Regulation SHO’s close-out requirement.

<sup>79</sup> See temporary Rule 204T(e)(3).

<sup>80</sup> See temporary Rule 204T(e)(2).

In addition, to help ensure that broker-dealers purchase sufficient shares to close out their fail to deliver positions, temporary Rule 204T(e) requires that the broker-dealer claiming pre-fail credit be net long or net flat on the settlement day on which the broker-dealer is claiming pre-fail credit.<sup>81</sup> In addition, the temporary Rule 204T(e) requires that the broker-dealer be able to demonstrate that it has complied with this requirement.<sup>82</sup> This requirement will enable the Commission and SROs to monitor more effectively whether or not a broker-dealer has complied with the requirements of temporary Rule 204T(e).

#### **D. Market Makers**

To allow market makers to facilitate customer orders in a fast moving market, similar to the September Emergency Order,<sup>83</sup> temporary rule includes a limited exception from the rule's close-out and borrowing requirements for fails to deliver attributable to bona fide market making activities by registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market. Specifically, temporary Rule 204T(a)(3) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security that is attributable to bona fide market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market (individually a "Market Maker," collectively "Market Makers"), the participant shall by no later than the beginning of regular trading hours on the third consecutive

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<sup>81</sup> See temporary Rule 204T(e)(4).

<sup>82</sup> See *id.*

<sup>83</sup> See *supra* note 77.

settlement day following the settlement date, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.<sup>84</sup>

In addition, similar to the September Emergency Order,<sup>85</sup> the temporary rule excepts Market Makers from the borrowing requirements of temporary Rule 204T(b) if the Market Maker can demonstrate that it does not have an open fail to deliver position at the time of any additional short sales. The borrowing requirements of the temporary rule apply to all broker-dealers from which a participant of a registered clearing agency receives trades for clearance and settlement. To allow Market Makers to facilitate customer orders, we do not believe that a Market Maker should be subject to the temporary rule's borrowing requirements if the Market Maker does not have an open fail to deliver at the time of any additional short sales.

#### **E. Sales Pursuant to Rule 144**

The temporary rule includes an exception for sales of all equity securities pursuant to Rule 144 under the Securities Act of 1933 ("Securities Act").<sup>86</sup> Specifically, temporary Rule 204T(a)(2) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in an equity security sold pursuant to Rule 144 for thirty-five consecutive settlement days after the settlement date for a sale in that equity security, the participant shall, by no later than the beginning of regular trading hours on the thirty-sixth

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<sup>84</sup> See temporary Rule 204T(a)(3). Unlike the September Emergency Order, however, the temporary rule does not require a Market Maker to which a fail to deliver position at a registered clearing agency is attributable to attest in writing to the market on which it is registered that the fail to deliver position at issue was established solely for the purpose of meeting its bona fide market making obligations and the steps the Market Maker has taken in an effort to deliver securities to its registered clearing agency. We believe the costs of such a requirement would outweigh the benefits. We note, however, that as with any exception, a broker-dealer would have to evidence eligibility for, and compliance with, the requirements of the exception.

<sup>85</sup> See *supra* note 77.

<sup>86</sup> See 17 CFR 230.144.



consecutive settlement day following the settlement date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.<sup>87</sup>

Regulation SHO provides an exception from the “locate” requirement of Rule 203(b)(1) for situations where a broker-dealer effects a short sale on behalf of a customer that is deemed to own the security pursuant to Rule 200 of Regulation SHO, although, through no fault of the customer or broker-dealer, it is not reasonably expected that the security will be in the physical possession or control of the broker-dealer by settlement date and, therefore, is a “short” sale under the marking requirements of Rule 200(g).<sup>88</sup> Rule 203(b)(2)(ii) of Regulation SHO provides that in such circumstances, delivery must be made on the sale as soon as all restrictions on delivery have been removed, and in any event no later than 35 days after trade date, at which time the broker-dealer that sold on behalf of the person must either borrow securities or close out the open position by purchasing securities of like kind and quantity.<sup>89</sup> In addition, recently we adopted amendments to the close-out requirement of Regulation SHO to allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 to be closed out within 35 rather than 13 consecutive settlement days.<sup>90</sup>

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<sup>87</sup> See temporary Rule 204T(a)(2).

<sup>88</sup> Pursuant to Rule 200(g)(2) of Regulation SHO, as adopted in August 2004, generally these sales were marked “short exempt.” See 2004 Regulation SHO Adopting Release, 69 FR at 48030-48031; but cf. Exchange Act Release No. 55970 (June 28, 2007), 72 FR 36348 (July 3, 2007) (removing the “short exempt” marking requirement).

<sup>89</sup> See 17 CFR 242.203(b)(2)(ii). In the 2004 Regulation SHO Adopting Release, the Commission stated that it believed that 35 calendar days is a reasonable outer limit to allow for restrictions on a security to be removed if ownership is certain. In addition, the Commission noted that Section 220.8(b)(2) of Regulation T of the Federal Reserve Board allows 35 calendar days to pay for securities delivered against payment if the delivery delay is due to the mechanics of the transactions. See 2004 Regulation SHO Adopting Release, 69 FR at 48015, n.72.

<sup>90</sup> See 2007 Regulation SHO Final Amendments, 72 FR at 45550-45551.

Securities sold pursuant to Rule 144 under the Securities Act are formerly restricted securities that a seller is “deemed to own,” as defined by Rule 200(a) of Regulation SHO.<sup>91</sup> The securities, however, may not be capable of being delivered on the settlement date due to processing delays related to removal of the restricted legend and, therefore, sales of these securities frequently result in fails to deliver. Consistent with our statements in connection with our recent amendments to Regulation SHO in connection with closing out fails to deliver in threshold securities sold pursuant to Rule 144, we believe that a close-out requirement of 35 consecutive settlement days from settlement date for fails to deliver resulting from sales of all equity securities sold pursuant to Rule 144, will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity (particularly if the purchases are for sizable quantities of stock). Because the security being sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such fail to deliver position by purchasing securities in the market.<sup>92</sup>

If, however, a fail to deliver position resulting from the sale of an equity security pursuant to Rule 144 is not closed out in accordance with temporary Rule 204T(a)(2), the borrowing requirements of temporary Rule 204T(b) will apply. Thus, if a participant does not

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<sup>91</sup> See 17 CFR 242.200(a).

<sup>92</sup> We understand that sellers that own restricted equity securities that wish to sell pursuant to an effective resale registration statement under Rule 415 under the Securities Act experience similar types of potential settlement delays as sales of securities pursuant to Rule 144 under the Securities Act. Thus, fails to deliver in such securities may be closed out in accordance with temporary Rule 204T(a)(2) if the fails to deliver resulted from sales of securities that were outstanding at the time they were sold and the sale occurred after a registration has become effective. In addition, we understand that sales pursuant to broker-assisted cashless exercises of compensatory options to purchase a company’s stock, may result in potential settlement delays and, therefore, fails to deliver. Such fails to deliver may be closed out in accordance with temporary Rule 204T(a)(2).

close out a fail to deliver position at a registered clearing agency in accordance with temporary Rule 204T(a)(2), the temporary rule prohibits the participant, and any broker-dealer from which it receives trades for clearance and settlement, including market makers, from accepting any short sale orders or effecting further short sales in the particular security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.<sup>93</sup>

## **V. Other Matters**

The Administrative Procedure Act generally requires an agency to publish notice of a proposed rulemaking in the Federal Register.<sup>94</sup> This requirement does not apply, however, if the agency “for good cause finds . . . that notice and public procedure are impracticable, unnecessary, or contrary to the public interest.”<sup>95</sup> Further, the Administrative Procedure Act also generally requires that an agency publish an adopted rule in the Federal Register 30 days before it becomes effective.<sup>96</sup> This requirement, however, does not apply if the agency finds good cause for making the rule effective sooner.<sup>97</sup>

For the reasons discussed throughout this release, we believe that we have good cause to act immediately to adopt this rule on an interim final temporary basis. The September Emergency Order, in which we adopted and made immediately effective temporary Rule 204T expires at 11:59 p.m. EDT on October 17, 2008. As discussed throughout this release, we have

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<sup>93</sup> See temporary Rule 204T(b).

<sup>94</sup> See 5 U.S.C. §553(b).

<sup>95</sup> Id.

<sup>96</sup> See 5 U.S.C. §553(d).

<sup>97</sup> Id.

determined it is necessary to act immediately and adopt this rule on an interim final temporary basis so that temporary rule 204T remains in effect in the form set forth herein following the expiration of the September Emergency Order.

This temporary rule takes effect on October 17, 2008. For the reasons discussed above, we have acted on an interim final temporary basis. We emphasize that we are requesting comments on the temporary rule and will carefully consider the comments we receive and respond to them in a subsequent release. Moreover, this is a temporary rule, and will expire on July 31, 2009. Setting a termination date for the rule will necessitate further Commission action no later than the end of that period if the Commission intends to continue the same, or similar, requirements contained in the temporary rule.

The sunset provision will enable the Commission to assess the operation of the temporary rule and intervening developments, including a restoration of stability to the financial markets, as well as public comments, and consider whether to continue the rule with or without modification or not at all.

We find that there is good cause to have the temporary rule take effect on October 17, 2008 and that notice and public procedure in advance of effectiveness of the rule are impracticable, unnecessary, and contrary to the public interest.<sup>98</sup>

## **VI. Request for Comment**

We are requesting comments from all members of the public. We will carefully consider the comments that we receive and intend to respond to them in a subsequent release. We seek

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<sup>98</sup> This finding also satisfies the requirements of 5 U.S.C. §808(2), allowing the rules to become immediately effective notwithstanding the requirements of 5 U.S.C. §801 (if a Federal agency finds that notice and public comment are “impractical, unnecessary, or contrary to the public interest,” a rule “shall take effect at such time as the Federal agency promulgating the rule determines.”).

comment generally on all aspects of the temporary rule. In addition, we seek comment on the following:

- The temporary rule requires participants to immediately close out a fail to deliver position by no later than the beginning of regular trading hours on the Close-Out Date. Should we narrow the close-out requirement further? Should we allow a longer or shorter period of time within which to close out a fail to deliver position? What would be the justifications for allowing a shorter or longer close-out period?
- Are there any operational or compliance issues related to complying with the requirement in temporary Rule 204T(a) to immediately purchase or borrow securities “by no later than the beginning of regular trading hours”? Should we allow a participant to take steps to purchase or borrow securities after the beginning of regular trading hours on the Close-Out Date to satisfy temporary Rule 204T(a)? If so, how much time after the beginning of regular trading hours should we provide? For example, should we allow trading during an opening auction that commences after the beginning of regular trading hours or should we provide until noon? Alternatively, should we allow participants to purchase or borrow securities at any time on the Close-Out Date to satisfy the temporary rule’s close-out requirement? What would be the costs and benefits of allowing additional time beyond the beginning of regular trading hours on the Close-Out Date for the participant to purchase or borrow securities to close out a fail to deliver position?
- Temporary Rule 204T(f)(1) defines “settlement date” as “the business day on which delivery of a security and payment of money is to be made through the facilities of a registered clearing agency in connection with the sale of a security.” Is this an appropriate definition of “settlement date”?

- Due to our expectation that delivery of securities on all sales should be made by settlement date, we state in the release that participants should consider having in place policies and procedures to monitor for the delivery of securities by settlement date. Should we adopt a rule requiring that participants have in place such policies and procedures?
- Should a de minimus amount of fails to deliver be excepted from the close-out requirements of the temporary rule? If so, what should be the de minimus amount?
- Should the temporary rule be expanded to apply to debt as well as equity securities? Please explain.
- The temporary rule requires that a participant purchase securities by no later than the beginning of regular trading hours on the third settlement day after the settlement date for a fail to deliver position resulting from a long sale transaction. What are the costs associated with purchasing versus borrowing securities to close out a fail to deliver position? Should we permit participants to close out a fail to deliver position for long sale transactions by borrowing as well as purchasing securities? Please explain.
- The temporary rule allows a participant to close out a fail to deliver position attributable to bona fide market making activity by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market by purchasing securities of like kind and quantity by no later than the beginning of regular trading hours on the third settlement day after the settlement date. Should this close-out period be a shorter or longer time-frame? Please explain. What would be the costs and benefits of a longer or shorter close-out period for such fails to deliver?

- The temporary rule does not include a complete exception from its close-out requirement for options market makers with fails to deliver resulting from short sales effected to establish or maintain a hedge on options positions. We seek comment regarding the impact of the temporary rule on options market makers that are subject to the close-out requirement of the temporary rule. For example, we seek comment regarding the impact of the temporary rule, if any, on liquidity, spread widths, and quote depth in the securities that are subject to the temporary rule.
- The temporary rule allows a participant to close out a fail to deliver position resulting from a sale of an equity security pursuant to Rule 144 of the Securities Act by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day after the settlement date. Are there other types of sales that encounter settlement delays due to processing requirements similar to sales of Rule 144 securities that should have an exception from the close-out requirements of temporary Rule 204T(a)? Please explain.
- What impact will the temporary rule have on borrowing costs? Please explain. What impact will the temporary rule have on legitimate short selling and market efficiency?
- An arrangement to borrow means a bona fide agreement to borrow the security such that the security being borrowed is set aside at the time of the arrangement solely for the person requesting the security. Should we define “arrangement to borrow” as requiring a contract between the broker-dealer and the lending source?
- Should temporary Rule 204T(b) require that participants and broker-dealers from which participants receive trades for clearance and settlement borrow securities prior to effecting further short sales, rather than allowing for either an arrangement to borrow or a borrow? If a fail to deliver position has not been closed out in accordance with

temporary Rule 204T, should we prohibit the participant, and any broker-dealer from which it receives trades for clearance and settlement, from effecting any further short sales until the fail to deliver position has been closed out?

- If a participant becomes subject to the requirements of temporary Rule 204T(b), the participant will be required to borrow or arrange to borrow securities prior to settlement at a registered clearing agency of the purchase to close out the fail to deliver position. What are the costs associated with this requirement?
- Temporary Rule 204T(c) imposes a notification requirement on participants. Will such a notification requirement impose operational or systems costs on participants? What types of communication mechanisms will participants use to comply with this requirement of the temporary rule? What will be the costs and benefits of this notification requirement?
- The temporary rule allows a broker-dealer to obtain pre-fail credit if it purchases securities in accordance with the conditions specified in temporary Rule 204T(e). Are there any operational or compliance concerns associated with the conditions of temporary Rule 204T(e)? To what extent, if any, will temporary Rule 204T(e) encourage broker-dealers to close out a fail to deliver position prior to the Close-Out Date?
- The temporary rule does not propose amendments to the “locate” requirement of Rule 203(b)(1) of Regulation SHO. In addition to the temporary rule, should we also require that broker-dealers arrange to borrow, or borrow, equity securities prior to effecting short sales in those equity securities? How would this impact the liquidity and availability of such equity securities overall? How would this affect lending rates for such equity securities?



- The temporary rule imposes a close-out requirement on fails to deliver for all equity securities. Due to this hard delivery requirement is it necessary to retain the “locate” requirement of Regulation SHO for short sales? What are the benefits of continuing to require that broker-dealers have a reasonable grounds to believe that a security can be borrowed so that it can be delivered by settlement date if a participant is required to immediately close out a fail to deliver position by no later than the beginning of regular trading hours on the Close-Out Date?
- The temporary rule does not allow any exceptions for fails to deliver due to mechanical aspects of corporate events, such as equity offers, including initial public offerings (“IPOs”),<sup>99</sup> and tender offers. Will the temporary rule cause any disruption to these corporate events? For example, will the temporary rule interfere with the ability of underwriters to provide price support? Would any disruption warrant an exception for certain corporate events? If so, should the exception focus on particular corporate events and why? How much time is needed for securities subject to such corporate events to be delivered? Would providing exceptions for such securities create opportunities for price manipulation?

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<sup>99</sup> See Amy Edwards and Kathleen Weiss Hanley, Short Selling in Initial Public Offerings (2008) <http://ssrn.com/abstract=981242> showing that fails to deliver in IPOs are not from “naked” short selling but instead seem to be related to fails to deliver resulting from long sales that result from underwriter price support. The aggregate fails to deliver in these stocks seem to persist for the typical price support period. Thus, the temporary rule’s close-out requirement could apply to a high proportion of such fails to deliver, potentially as much as 2.5% of the shares offered on average. Edwards and Hanley believe that such a result could have a substantial impact on the aftermarket of IPOs.

## **VII. Paperwork Reduction Act**

### **A. Background**

Temporary Rule 204T contains “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“Paperwork Reduction Act”).<sup>100</sup> We submitted these requirements to the Office of Management and Budget (“OMB”) for review and approval in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13. Separately, we have submitted the collection of information to OMB for review and approval in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. The OMB has approved the collection of information on an emergency basis with an expiration date of April 30, 2009. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The title for the collection of information is: “Temporary Rule 204T” and the OMB control number for the collection of information is 3235-0647.

Temporary Rule 204T will substantially restrict the practice of “naked” short selling in all equity securities by strengthening the delivery requirements for such securities.<sup>101</sup> Temporary Rule 204T(a) amends Regulation SHO to require that participants of a clearing agency registered with the Commission deliver securities by settlement date, or if the participants have not delivered shares by settlement date, the participants must, by no later than the beginning of regular trading hours on the settlement day following the settlement date (the “Close-Out Date”),

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<sup>100</sup> 44 U.S.C. 3501 *et seq.*

<sup>101</sup> As noted above, in a “naked” short sale, the short seller does not borrow or arrange to borrow securities in time to make delivery to the buyer within the standard three-day settlement period. As a result, the seller fails to deliver securities to the buyer when delivery is due.

immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.

A participant that does not comply with the temporary rule's close-out requirements will have violated temporary Rule 204T. In addition, the participant and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security either for itself or for the account of another, unless it has previously arranged to borrow or has borrowed the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.<sup>102</sup>

Several provisions under temporary Rule 204T will impose a new "collection of information" within the meaning of the Paperwork Reduction Act. These collections of information are mandatory for broker-dealers relying on the rule. The information collected will be retained and/or provided to other entities pursuant to the specific rule provisions and will be available to the Commission and SRO examiners upon request. The information collected will aid the Commission and SROs in monitoring compliance with the rule's requirements.

### **1. Allocation Notification Requirement**

Similar to Rule 203(b)(3)(vi) of Regulation SHO, temporary Rule 204T(d) provides that a participant may reasonably allocate its responsibility to close out a fail to deliver position to another broker-dealer for which the participant clears or from which the participant receives trades for settlement.<sup>103</sup> Unlike Rule 203(b)(3)(vi) of Regulation SHO, however, temporary

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<sup>102</sup> See temporary Rule 204T(b).

<sup>103</sup> See 17 CFR 242.203(b)(3)(vi). Rule 203(b)(3)(vi) provides that "[i]f a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this paragraph (b)(3) relating to such fail to deliver position shall apply to the

Rule 204T(d) imposes an additional notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements (the "allocation notification requirement").<sup>104</sup>

Specifically, temporary Rule 204T(d) provides that a broker or dealer that has been allocated a portion of a fail to deliver position that does not comply with the provisions of temporary Rule 204T(a) must immediately notify the participant that it has become subject to the borrowing requirements of temporary Rule 204T(b).<sup>105</sup> This allocation notification requirement is designed to help ensure that participants that receive trades for clearance and settlement from broker-dealers will be on notice that the broker-dealer is subject to the borrow requirements of temporary Rule 204T(b) until the fail to deliver position has been closed out.

Such notification will require a broker-dealer to determine that it has a fail to deliver that does not comply with the provisions of temporary Rule 204T(a) and, therefore, has become subject to the requirements of temporary Rule 204T(b). After making such determination, the temporary rule requires that the broker-dealer notify such participant regarding this information.

We estimate that such procedures will take a broker-dealer no more than approximately 0.16 hours (10 minutes) to complete. We base this estimate in part on the fact that, in accordance with Rule 203(b)(3)(vi) of Regulation SHO, participants are permitted to allocate responsibility to close out a portion of a fail to deliver position to a broker-dealer that is responsible for the fail to deliver position; the fact that most broker-dealers already have the necessary communication mechanisms in place and are already familiar with notification

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portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant."

<sup>104</sup> See temporary Rule 204T(d).

<sup>105</sup> See *id.*

processes and procedures to comply with the borrowing requirements of Rule 203(b)(3)(iv) of Regulation SHO for threshold securities; and the fact that broker-dealers will be able to continue to use the same communication mechanisms, processes and procedures to comply with the notification requirement of temporary Rule 204T(b). On average, participants estimate that currently it takes approximately 0.16 hours (10 minutes) to notify broker-dealers pursuant to Rule 203(b)(3)(iv) of Regulation SHO.<sup>106</sup>

If a broker-dealer has been allocated a portion of a fail to deliver position in an equity security and after the beginning of regular trading hours on the Close-Out Date, the broker-dealer has to determine whether or not that portion of the fail to deliver position was not closed out in accordance with temporary Rule 204T(a), we estimate that a broker-dealer will have to make such determination with respect to approximately 1.76 equity securities per day.<sup>107</sup>

As of December 31, 2007, there were 5,561 registered broker-dealers. Each of these broker-dealers could clear trades through a participant of a registered clearing agency and, therefore, become subject to the notification requirements of temporary Rule 204T(b). We estimate a total of 2,466,415 notifications in accordance with temporary Rule 204T(b) across all broker-dealers (that were allocated responsibility to close out a fail to deliver position) per year

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<sup>106</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

<sup>107</sup> OEA estimates that there are approximately 9,809 fail to deliver positions per settlement day. Across 5,561 broker-dealers, the number of securities per broker-dealer per day is approximately 1.76 equity securities. During the period from January to July 2008, approximately 4,321 new fail to deliver positions occurred per day. The NSCC data for this period includes only securities with at least 10,000 shares in fails to deliver. To account for securities with fails to deliver below 10,000 shares, the figure is multiplied by a factor of 2.27. The factor is estimated from a more complete data set obtained from NSCC during the period from September 16, 2008 to September 22, 2008. It should be noted that these numbers include securities that were not subject to the close-out requirement of Rule 203(b)(3) of Regulation SHO.

(5,561 broker-dealers notifying participants once per day<sup>108</sup> on 1.76 securities, multiplied by 252 trading days in a year). The total estimated annual burden hours per year will be approximately 394,626 burden hours (2,466,415 multiplied by 0.16 hours/notification). We estimate that the paperwork compliance for the allocation notification requirement for each broker-dealer will be approximately 71.0 burden hours per year.

## **2. Demonstration Requirement for Fails to Deliver on Long Sales**

Temporary Rule 204T(a)(1) includes an exception from temporary rule's close-out requirement for fail to deliver positions resulting from long sales of all equity securities. Under this exception, if a participant has a fail to deliver position at a registered clearing agency in an equity security and can demonstrate on its books and records that such fail to deliver position resulted from a long sale (the "demonstration requirement for fails to deliver on long sales"), such participant will have until no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date to immediately close out the fail to deliver position by purchasing securities of like kind and quantity.<sup>109</sup>

This provision allows a participant an additional two settlement days in which to close out the fail to deliver position that resulted from a long sale, provided that the participant's books and records reflect the fact that the fail to deliver resulted from a long sale.<sup>110</sup>

The demonstration requirement will require a participant of a registered clearing agency to determine whether it has a fail to deliver position at a registered clearing agency in an equity security that resulted from a long sale. After making such determination, the temporary rule

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<sup>108</sup> Because failure to comply with the close-out requirements of temporary Rule 204T(a) is a violation of the temporary rule, we believe that a broker-dealer would make the notification to a participant that it is subject to the borrowing requirements of temporary Rule 204T(b) at most once per day.

<sup>109</sup> See temporary Rule 204T(a)(1).

<sup>110</sup> See *id.*

requires that the participant demonstrate or reflect this information in its books and records. We estimate that such procedures will take a participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to complete.

We base this estimate on the fact that, to comply with Regulation SHO's marking requirements, broker-dealers are already required to ascertain whether a customer is "deemed to own" the securities being sold before marking a sell order "long" and, if the securities are not in the broker-dealer's physical possession or control, whether the broker-dealer reasonably expects that the shares will be in the broker-dealer's physical possession or control by settlement date.<sup>111</sup> This reasonableness determination includes consideration of whether or not a prior sale resulted in a fail to deliver position. In addition, broker-dealers already must comply with the documentation requirement contained in the "locate" requirement of Rule 203(b)(1) of Regulation SHO. Participants will be able to use similar mechanisms, processes and procedures to demonstrate compliance with the temporary rule's close-out requirement for fails to deliver resulting from long sales as they use for compliance with the current requirements of Regulation SHO.

If a participant of a registered clearing agency has a fail to deliver position in an equity security at a registered clearing agency and determined that such fail to deliver position resulted from a long sale, we estimate that a participant of a registered clearing agency will have to make such determination with respect to approximately 34 securities per day.<sup>112</sup>

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<sup>111</sup> See 17 CFR 242.200(g)(1).

<sup>112</sup> OEA estimates approximately 68% of trades are long sales and applies this percentage to the number of fail to deliver positions per day. 68% of 50 securities per day is 34 securities per day. The 68% figure is estimated as 100% minus the proportion of short sale trades found in the Regulation SHO Pilot Study. See <http://www.sec.gov/news/studies/2007/regshopilot020607.pdf>.

As of July 31, 2008, there were 197 participants of NSCC, the primary registered clearing agency responsible for clearing U.S. transactions that were registered as broker-dealers. We estimate a total of 1,687,896 demonstrations in accordance with temporary Rule 204T(a)(1) across all participants per year (197 participants checking for compliance once per day on 34 securities, multiplied by 252 trading days in a year). The total approximate estimated annual burden hour per year will be approximately 270,063 burden hours (1,687,896 multiplied by 0.16 hours/documentation). We estimate that the paperwork burden for the temporary demonstration provision for each participant will be approximately 1,371 burden hours per year.

### **3. Pre-Borrow Notification Requirement**

The borrowing requirements of temporary Rule 204T(b) are similar to the requirements of Rule 203(b)(3)(iv) of Regulation SHO for a participant that has failed to close out a fail to deliver position in a threshold security that has persisted for thirteen consecutive settlement days.<sup>113</sup> Unlike the current borrow requirements of Rule 203(b)(3)(iv) of Regulation SHO, however, temporary Rule 204T(c) specifies that participants must notify all broker-dealers from which they receive trades for clearance and settlement that a fail to deliver position has not been closed out in accordance with temporary Rule 204T(a) (the “pre-borrow notification requirement”).

Specifically, temporary Rule 204T(c) provides that the participant must notify any broker or dealer from which it receives trades for clearance and settlement, including any market maker

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<sup>113</sup> See 17 CFR 242.203(b)(3)(iv). Rule 203(b)(3)(iv) of Regulation SHO provides that “[i]f a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a threshold security for thirteen consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of this section, may not accept a short sale order in the threshold security from another person, or effect a short sale in the threshold security for its own account, without borrowing the security or entering into a bona fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.”



that would otherwise be entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,<sup>114</sup> (1) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of temporary Rule 204T(a), and (2) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.<sup>115</sup>

The notification requirement will involve a participant of a registered clearing agency determining whether it has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of temporary Rule 204T(a), and when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency. After making such determinations, the temporary rule requires that the participant notify such broker-dealer regarding this information.

We estimate that such procedures will take a participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to complete.<sup>116</sup> We base this estimate in part on the fact that most participants already notify broker-dealers for which they receive orders for clearance and settlement that the participant has a fail to deliver position in a threshold security that has not been closed out in order to comply with the borrow requirements of Rule 203(b)(3)(iv) of Regulation SHO for threshold securities; the fact that most participants already have the necessary communication mechanisms in place and are already familiar with notification processes and procedures to comply with the borrow requirements of Rule

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<sup>114</sup> See 17 CFR 203(b)(2)(iii) (providing for an exception from the “locate” requirement for market makers engaged in bona fide market making in that security at the time of the short sale).

<sup>115</sup> See temporary Rule 204T(c).

<sup>116</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

203(b)(3)(iv) of Regulation SHO for threshold securities; and the fact that participants will be able to continue to use the same communication mechanisms, processes and procedures to notify any broker-dealers from which they receive trades for clearance and settlement of the information required by the temporary rule's notification requirement as they use for compliance with Regulation SHO.

If a participant of a registered clearing agency has a fail to deliver position in an equity security and after the beginning of regular trading hours on the Close-Out Date (or, in the case of a fail to deliver that resulted from a long sale, on the third consecutive settlement day following the settlement date), the participant has to determine whether or not the fail to deliver position was closed out in accordance with temporary Rule 204T(a), we estimate that a participant of a registered clearing agency will have to make such determination with respect to approximately 50 equity securities per day.<sup>117</sup>

As of July 31, 2008, there were 197 participants of NSCC, the primary registered clearing agency responsible for clearing U.S. transactions that were registered as broker-dealers.<sup>118</sup> We estimate a total of 2,482,200 notifications in accordance with temporary Rule 204T(c) across all

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<sup>117</sup> OEA estimates that there are approximately 9,809 fail to deliver positions per day. Across 197 broker-dealer participants of the NSCC, the number of securities per participant per day is approximately 50 equity securities. During the period from January to July 2008, approximately 4,321 new fail to deliver positions occurred per day. The NSCC data for this period includes only securities with at least 10,000 shares in fails to deliver. To account for securities with fails to deliver below 10,000 shares, the figure is grossed-up by a factor of 2.27. The factor is estimated from a more complete data set obtained from NSCC during the period from September 16, 2008 to September 22, 2008. It should be noted that these numbers include securities that were not subject to the close-out requirement of Rule 203(b)(3) of Regulation SHO.

<sup>118</sup> Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that will implicate the close-out requirements of the temporary rule. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver will not trigger the close-out requirement of the temporary rule.

participants per year (197 participants notifying broker-dealers once per day on 50 securities, multiplied by 252 trading days in a year). The total estimated annual burden hours per year will be approximately 397,152 burden hours (2,482,200 @ 0.16 hours/documentation). We estimate that the paperwork burden for the notification requirement for each participant will be approximately 2,016 burden hours per year.

#### **4. Certification Requirement**

The temporary rule includes an exception from the borrowing requirements for any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. Specifically, temporary Rule 204T(b)(1) provides that a broker or dealer shall not be subject to the requirements of temporary Rule 204T(b) if the broker or dealer timely certifies to the participant that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that the broker or dealer is in compliance with the requirements of temporary Rule 204T(e) (the “certification requirement”).<sup>119</sup>

This certification requirement will allow a broker-dealer to avoid being subject to the temporary rule’s borrowing requirements if it can demonstrate that it did not incur a fail to deliver position in the security on settlement date. Also, by requiring the broker-dealer to demonstrate that it was not responsible for any part of the fail to deliver position of the participant, the information collected will help ensure that broker-dealers are complying with the requirements of the temporary rule.

This certification requirement will require a broker-dealer to determine that it has not incurred a fail to deliver position on settlement date in an equity security for which the

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<sup>119</sup> See temporary Rule 204T(b)(1).

participant has a fail to deliver position at a registered clearing agency or that the broker-dealer is in compliance with the requirements set forth in the Pre-Fail Credit provision of temporary Rule 204T(e). After making such determinations, the broker-dealer will have to certify this information to the participant. We estimate that such procedures will take a broker-dealer no more than approximately 0.16 hours (10 minutes) to complete.

We base this estimate, in part, on the fact that, to comply with the close-out requirements of Rule 203(b) of Regulation SHO, current industry practice for some participants that are registered broker-dealers is to document purchases made on settlement days 11, 12, and 13 to demonstrate that such participants do not have a close-out obligation under Regulation SHO. On average, participants informed us that such documentation takes approximately 0.16 hours (10 minutes).<sup>120</sup>

If the broker-dealer determines that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or has purchased securities in accordance with the conditions specified in temporary Rule 204T(e), we estimate that a broker-dealer will have to make such determinations with respect to approximately 1.76 securities per day. As of December 31, 2007, there were 5,561 registered broker-dealers. Each of these broker-dealers may clear trades through a participant of a registered clearing agency. We estimate that on average, a broker-dealer will have to certify to the participant that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or, alternatively, that it is in compliance with the requirements set forth in the Pre-Fail Credit provision of the temporary Rule 204T(e), 2,466,415 times per year

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<sup>120</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

(5,561 broker-dealers certifying once per day on 1.76 securities, multiplied by 252 trading days in a year). The total approximate estimated annual burden hour per year will be approximately 394,626 burden hours (2,466,415 multiplied by 0.16 hours/certification). We estimate that the paperwork burden for the certification provision for each broker-dealer will be approximately 71.0 burden hours per year.

## **5. Pre-Fail Credit Demonstration Requirement**

To encourage close outs of fail to deliver positions prior to the Close-Out Date, temporary Rule 204T(e) provides that a broker-dealer can satisfy the temporary rule's close-out requirement by purchasing securities in accordance with the conditions of that provision (i.e., broker-dealers will receive "pre-fail credit" for the purchase), including a condition that the broker-dealer demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is claiming credit (the "Pre-Fail Credit demonstration requirement").

Temporary Rule 204T(e) provides that even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with temporary Rule 204T(a), or has not allocated a fail to deliver position to a broker-dealer in accordance with temporary Rule 204T(d), a broker or dealer may receive credit for purchasing securities prior to the beginning of regular trading hours on the Close-Out Date if, among other things, the purchase is executed on, or after, trade date but by no later than the end of regular trading hours on settlement date and the broker or dealer can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is claiming credit.<sup>121</sup>

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<sup>121</sup> See temporary Rule 204T(e).

The Pre-Fail Credit provision is intended to encourage broker-dealers to close out fail to deliver positions prior to the beginning of regular trading hours on the Close-Out Date. By requiring, among other things, that the broker-dealer demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker-dealer is claiming credit, the information collected will help ensure that broker-dealers purchase sufficient shares to close out their fail to deliver position prior to the beginning of regular trading hours on the Close-Out Date.

Such demonstration requirement will require a broker-dealer that purchased securities in accordance with the conditions specified in temporary Rule 204T(e) to determine that it has a net long position or net flat position on the settlement day for which the broker-dealer is claiming credit. After making such determination, the temporary rule requires that the broker-dealer demonstrate such information on its books and records. We estimate that such procedures will take a broker-dealer no more than approximately 0.16 hours (10 minutes) to complete.

We base this estimate on the fact that, to comply with the close-out requirement of Rule 203(b)(3) of Regulation SHO, current industry practice for some participants that are registered broker-dealers is to document purchases made on settlement days 11, 12, and 13 to demonstrate that such participants do not have a close-out obligation under Regulation SHO. On average, participants informed us that such documentation takes approximately 0.16 hours (10 minutes).<sup>122</sup>

If a broker-dealer purchased securities in accordance with the conditions specified in temporary Rule 204T(e) and determined that it has a net long position or net flat position on the

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<sup>122</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

settlement day for which the broker-dealer is claiming credit, we estimate that a broker-dealer will have to make such determination with respect to approximately 1.76 securities per day.<sup>123</sup>

As of December 31, 2007, there were 5,561 registered broker-dealers. We estimate that on average, a broker-dealer will have to demonstrate in its books and records that it has a net long position or net flat position on the settlement day for which the broker-dealer is claiming credit, 2,466,415 times per year (5,561 broker-dealers checking for compliance once per day on 1.76 securities, multiplied by 252 trading days in a year). The total approximate estimated annual burden hour per year will be approximately 394,626 burden hours (2,466,415 multiplied by 0.16 hours/demonstration). We estimate that the paperwork burden for the temporary Pre-Fail Credit provision for each broker-dealer will be approximately 71.0 burden hours per year.

## **6. Market Maker Demonstration Requirement**

To allow market makers to facilitate customer orders in a fast moving market, the temporary rule includes a limited exception from the rule's close-out requirement for fails to deliver attributable to bona fide market making activities by registered market makers, options market makers, or other market makers obligated to quote in the over-the-counter market (collectively, "Market Makers"). Under this exception, a participant must close out the fail to deliver position attributable to a Market Maker by no later than the beginning of regular trading hours on the morning of the third settlement day after the settlement date for the transaction that resulted in the fail to deliver position. The borrowing requirements of the temporary rule do not apply to Market Makers provided the Market Maker can demonstrate that it does not have an open fail to deliver position at the time of any additional short sales (the "Market Maker demonstration requirement").

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<sup>123</sup> See *supra*, note 107.

By requiring a Market Maker to demonstrate that it does not have an open fail to deliver position at the time of any additional short sales and, thus, avoid being subject to the temporary rule's pre-borrow requirements, the information collected will help ensure that Market Makers are complying with the requirements of temporary Rule 204T(b)(2).

This requirement will require a Market Maker to determine whether it has an open fail to deliver position at the time of any additional short sales in the particular equity security in which there is a fail to deliver position at a registered clearing agency. After making such a determination, the temporary rule requires that the Market Maker demonstrate that it does not have an open fail to deliver position in that equity security. We estimate that such procedures will take a Market Maker no more than approximately 0.16 hours (10 minutes) to complete.<sup>124</sup>

If a participant of a registered clearing agency has a fail to deliver position in an equity security at a registered clearing agency that is attributable to a Market Maker and the Market Maker, in seeking to avoid the borrowing requirements of temporary Rule 204T(b), has determined that it does not have an open fail to deliver position, we estimate that such Market Maker will have to make such determination with respect to approximately 15 securities per day.<sup>125</sup>

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<sup>124</sup> We base this estimate on information provided to our staff by three large, three medium, and three small firms that engage in market making activities currently complying with temporary Rule 204T, pursuant to the September Emergency Order, which has similar requirements to temporary Rule 204(T)(b)(2) of this release.

<sup>125</sup> OEA estimates that there are approximately 9,809 fail to deliver positions per day. An upper bound on the number of fail to deliver positions per day due to market makers is 9,809. Across 656 market makers, the number of securities per market maker per day is approximately 15 equity securities. During the period from January to July 2008, approximately 4,321 new fail to deliver positions occurred per day. The NSCC data for this period includes only securities with at least 10,000 shares in fails to deliver. To account for securities with fails to deliver below 10,000 shares, the figure is grossed-up by a factor of 2.27. The factor is estimated from a more complete data set obtained from NSCC during the period from September 16, 2008 to September 22, 2008. It should be noted that these numbers include securities that were not subject to the close-out requirement of Rule 203(b)(3) of Regulation SHO.



As of December 31, 2007, there were 656 Market Makers.<sup>126</sup> We estimate a total of 2,479,680 written demonstrations in accordance with temporary Rule 204T(b)(1) across all Market Makers per year (656 Market Makers demonstrating once per day on 15 securities, multiplied by 252 trading days in a year). The total estimated annual burden hour per year will be approximately 396,749 burden hours (2,479,680 multiplied by 0.16 hours/demonstration). We estimate that the paperwork burden for the Market Maker demonstration requirements for each Market Maker will be approximately 604.8 burden hours per year.

## **B. Request for Comment**

We invite comment on these estimates and assumptions. Pursuant to 44 U.S.C. 3506(c)(2)(B), we request comment in order to: (a) evaluate whether the collection of information is necessary for the proper performance of our functions, including whether the information will have practical utility; (b) evaluate the accuracy of our estimate of the burden of the collection of information; (c) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; and (d) evaluate whether there are ways to minimize the burden of the collection of information on those who respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Florence E. Harmon, Acting Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090, with

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<sup>126</sup> These numbers are based on OEA's review of 2007 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

reference to File No. S7-30-08. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File No. S7-30-08, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 100 F Street, NE, Washington, DC 20549-1090. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

## **VIII. Cost-Benefit Analysis**

### **A. Summary**

The Commission is sensitive to the costs and benefits of its rules. Commenters should provide analysis and data to support their views on the costs and benefits associated with the temporary rule.

We are adopting, as an interim final temporary rule, Rule 204T, under the Exchange Act. The temporary rule is intended to address abusive “naked” short selling in all equity securities by requiring that participants of a registered clearing agency deliver securities by settlement date, or if the participants have not delivered shares by settlement date, the participants must, by no later than the beginning of regular trading hours on the Close-Out Date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity.

If a participant does not purchase or borrow shares, as applicable, to close out a fail to deliver position in accordance with temporary Rule 204T(a), the participant will have violated the temporary rule. In addition, the temporary rule imposes on the participant for its own trades and on all broker-dealers from which that participant receives trades for clearance and settlement

(including introducing and executing brokers), a requirement to borrow or arrange to borrow securities prior to accepting or effecting further short sales in that security.<sup>127</sup>

To the extent that a participant becomes subject to the borrowing requirements of temporary Rule 204T(b), a broker-dealer that clears through the participant can avoid being subject to the borrowing requirements of temporary Rule 204T(b) if the broker-dealer can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. Moreover, to allow Market Makers to facilitate customer orders in a fast moving market without possible delays associated with complying with the pre-borrow penalty provision of temporary Rule 204T(b), the borrowing requirements of the temporary rule do not apply to Market Makers provided the Market Maker can show that it does not have an open fail to deliver position at the time of any additional short sales.<sup>128</sup>

Similar to Rule 203(b)(3)(vi) of Regulation SHO, temporary Rule 204(d) provides that a participant may reasonably allocate its responsibility to close out a fail to deliver position to another broker-dealer for which the participant clears trades, or from which it receives trades for settlement.<sup>129</sup> Unlike Rule 203(b)(3)(vi) of Regulation SHO, however, temporary Rule 204T(d) imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements.<sup>130</sup>

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<sup>127</sup> See temporary Rule 204T(b).

<sup>128</sup> See temporary Rule 204T(b)(2).

<sup>129</sup> See 17 CFR 242.203(b)(3)(vi). Rule 203(b)(3)(vi) provides that “[i]f a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer’s short position, then the provisions of this paragraph (b)(3) relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.”

<sup>130</sup> See temporary Rule 204T(d).

In addition, the temporary rule provides that if a participant has a fail to deliver position at registered clearing agency in an equity security and can demonstrate on its books and records that such fail to deliver position resulted from a long sale, such participant has until no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date to immediately close out the fail to deliver position by purchasing securities of like kind and quantity.

The temporary rule also extends the close-out requirement for fails to deliver attributable to bona fide market making activities by Market Makers by requiring a participant to close out the fail to deliver position attributable to a Market Maker by no later than the beginning of regular trading hours on the third settlement day after the settlement date for the transaction that resulted in the fail to deliver position.

In addition, consistent with Rule 203(b)(3)(ii) of Regulation SHO, the temporary rule includes an exception for sales of securities pursuant to Rule 144 of the Securities Act.<sup>131</sup> Specifically, temporary Rule 204T(a)(2) provides that if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security sold pursuant to Rule 144 for thirty-five consecutive settlement days after the settlement date for a sale in that equity security, the participant shall, by no later than the beginning of regular trading hours on the thirty-sixth consecutive settlement day following the settlement date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity.<sup>132</sup>

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<sup>131</sup> See 17 CFR 242.203(b)(3)(ii).

<sup>132</sup> See temporary Rule 204T(a)(2).

If, however, a fail to deliver position resulting from the sale of an equity security pursuant to Rule 144 is not closed out in accordance with temporary Rule 204T(a)(2), the participant is subject to the borrow requirements in temporary Rule 204T(b). Thus, if the fail to deliver position persists beyond thirty-five consecutive settlement days, the temporary rule prohibits a participant of a registered clearing agency, and any broker-dealer from which it receives trades for clearance and settlement, from accepting any short sale orders or effecting further short sales in the particular security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency.<sup>133</sup>

Although we recognize the temporary rule may impose increased borrowing costs to assure settlement in accordance with the requirements of the temporary rule, which may increase the costs of legitimate short selling, we believe that the requirements of the temporary rule are necessary to achieve our goal of further reducing fails to deliver and addressing abusive “naked” short selling.

## **B. Benefits**

The temporary rule will substantially restrict the practice of “naked” short selling in all equity securities by strengthening the delivery requirements for such securities. By requiring that participants of a registered clearing agency deliver securities by settlement date, or if the participants have not delivered shares by settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity, the temporary rule also furthers our goals of limiting fails to deliver and helping to reduce the possibility that

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<sup>133</sup> See temporary Rule 204T(b).

abusive “naked” short selling may contribute to disruption in the securities markets. This, in turn, will help to ensure that investors remain confident that trading can be conducted without the influence of illegal manipulation. The temporary rule also furthers the goals of helping to maintain fair and orderly markets against the threat of sudden and excessive fluctuations of securities prices and substantial disruption in the functioning of the securities markets. The temporary rule also promotes the prompt and accurate clearance and settlement of transactions in equity securities.

In addition, the temporary rule will help to further reduce the number of fails to deliver. These fails may create a misleading impression of the market for these securities. Large and persistent fails to deliver may have a negative effect on shareholders, potentially depriving them of the benefits of ownership, such as voting and lending. Thus, by facilitating the prompt receipt of shares, the temporary rule will help enable investors to receive the benefits associated with share ownership.

Persistent fails to deliver in a security may also be perceived by potential investors negatively and may affect their decision about making a capital commitment. Thus, by providing greater assurance that securities will be delivered and, thereby, alleviating investor apprehension as they make investment decisions, the temporary rule will benefit issuers in that an increase in investor confidence in the market for their securities will facilitate investment in their securities.

### **1. Close-out Requirements**

By requiring that participants of a registered clearing agency deliver securities by settlement date, or if the participants have not delivered shares by settlement date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and

quantity, the temporary rule will help restore, maintain, and enhance investor confidence in the securities markets. It will also help reduce manipulative schemes involving “naked” short selling in equity securities. Sellers that fail to deliver securities on settlement date may enjoy fewer restrictions than if they were required to deliver the securities within a reasonable period of time, and such sellers may attempt to use this additional freedom to engage in trading activities that deliberately depress the price of a security. Thus, the temporary rule’s close-out requirements are expected to remove a potential means of manipulation, thereby decreasing the possibility of artificial market influences and contributing to price efficiency.

Under temporary Rule 204T(a)(1), a participant that has a fail to deliver position at a registered clearing agency in an equity security and can demonstrate on its books and records that such fail to deliver position resulted from a long sale, will have until no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date to immediately close out the fail to deliver position by purchasing securities of like kind and quantity. This provision allows participants an additional two settlement days to close out fail to deliver positions that result from long sales, provided that the participant’s books and records reflect the fact that the fail to deliver resulted from a long sale.<sup>134</sup> We believe this exception to temporary Rule 204T(a)’s close-out requirement benefits participants because the two additional days to close-out these fail to deliver positions may reduce close-out costs for such participants.

The temporary rule also extends temporary Rule 204T(a)’s close-out requirement for fails to deliver attributable to bona fide market making activities by Market Makers by requiring a participant to close out the fail to deliver position attributable to a Market Maker by no later than

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<sup>134</sup> See temporary Rule 204T(a)(1).

the beginning of regular trading hours on the third settlement day after the settlement date. We believe this exception to temporary Rule 204T(a)'s close-out requirement benefits participants because the two additional days to close-out these fail to deliver positions may reduce close-out costs for such participants.

Similar to Rule 203(b)(3)(vi) of Regulation SHO, temporary Rule 204(d) allows a participant to reasonably allocate its responsibility to close out a fail to deliver position to another broker-dealer for which the participant clears trades, or from which it receives trades for settlement. This allocation provision benefits participants because if a participant can identify the accounts of broker-dealers for which they clear or from which they receive trades for settlement, the participant can allocate the responsibility to close out the fail to deliver position to the particular broker-dealer account(s) whose trading activities caused the fail to deliver position provided the allocation is reasonable and, therefore, the allocated broker-dealer rather than the participant will incur any costs associated with the temporary rule's close-out requirement.

In addition, temporary Rule 204T(d) imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements. Thus, under the temporary rule's allocation provision, if the broker-dealer does not comply with the provisions of temporary Rule 204T(a), it must immediately notify the participant that it has become subject to the borrowing requirements of temporary Rule 204T(b).<sup>135</sup> This allocation notification requirement is intended to let participants know when a broker-dealer from which the participant receives trades for clearance and settlement has become subject to the temporary rule's borrowing requirements. The notification requirement furthers the Commission's goals of limiting fails to deliver and addressing abusive "naked" short selling by promoting the prompt

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<sup>135</sup> See temporary Rule 204T(d).



and accurate clearance and settlement of transactions involving equity securities. The notification requirement will also help ensure that participants that receive trades for clearance and settlement from broker-dealers will be on notice that the broker-dealer is subject to the borrow requirements of temporary Rule 204T(b) until the fail to deliver position has been closed out.

Moreover, under the temporary rule's Pre-Fail Credit provision, a broker or dealer may receive credit for purchasing securities prior to the beginning of regular trading hours on the Close-Out Date if, among other things, the purchase is executed on, or after, trade date but by no later than the end of regular trading hours on settlement date and the broker or dealer can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is claiming credit. The Pre-Fail Credit provision is intended to encourage earlier close out of fails to deliver in all equity securities and, therefore, to the extent used could result in a reduction of persistent fails to deliver.

## **2. Borrowing Requirements**

The borrowing requirements of temporary Rule 204T(b) are similar to the requirements of Rule 203(b)(3)(iv) of Regulation SHO for a participant that has not closed out a fail to deliver position in a threshold security that has persisted for thirteen consecutive settlement days.<sup>136</sup> Similar to Regulation SHO, the temporary rule is aimed in part at addressing potentially abusive “naked” short selling in equity securities. To that end, we believe it is appropriate to include in the temporary rule borrowing requirements for broker-dealers, including participants, that sell short a security that has a fail to deliver position that has not been closed out in accordance with the requirements of the temporary rule. We believe that the borrowing requirements of

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<sup>136</sup> See 17 CFR 242.203(b)(3)(iv).

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

Unlike the current borrow requirements of Rule 203(b)(3)(iv) of Regulation SHO, however, the borrow requirements of the temporary rule specify that participants must notify all broker-dealers from which they receive trades for clearance and settlement that a fail to deliver position in an equity security has not been closed out in accordance with temporary Rule 204T(a).<sup>137</sup> This notification requirement in temporary Rule 204T(c) is intended to ensure that all broker-dealers that submit trades for clearance and settlement to a participant that has a fail to deliver position in an equity security that has not been closed out in accordance with temporary Rule 204T(a) are on notice that all short sales in that security will be subject to the borrowing requirements of temporary Rule 204T(b) until the fail to deliver position has been closed out.

However, if a participant becomes subject to the borrowing requirements of temporary Rule 204T(b) because it did not close out a fail to deliver position by no later than the beginning of regular trading hours on the settlement date for the transaction, a broker-dealer that clears through the participant will not also be subject to the borrowing requirements of temporary Rule 204T(b) if the broker-dealer can demonstrate that it was not responsible for any part of the fail to

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<sup>137</sup> See temporary Rule 204T(c).

deliver position of the participant.<sup>138</sup> This exception allows a broker-dealer to avoid being subject to the borrowing requirements of the temporary rule if the broker-dealer can demonstrate that it did not incur a fail to deliver position in the security on settlement date.

Moreover, the borrowing requirements of the temporary rule will not apply to Market Makers, provided that the Market Maker can show that it does not have an open fail to deliver position at the time of any additional short sales.<sup>139</sup> This provision is intended to allow Market Makers to facilitate customer orders in a fast moving market without possible delays associated with complying with the pre-borrow penalty provision of temporary Rule 204T(b).

### **3. Sales of Securities Pursuant to Rule 144**

Securities sold pursuant to Rule 144 of the Securities Act are formerly restricted securities that a seller is “deemed to own,” as defined by Rule 200(a) of Regulation SHO.<sup>140</sup> The securities, however, may not be capable of being delivered on the settlement date due to processing delays related to removal of the restricted legend and, therefore, sales of these securities frequently result in fails to deliver. Consistent with our statements in connection with our recent amendments to Regulation SHO in connection with closing out fails to deliver in threshold securities sold pursuant to Rule 144,<sup>141</sup> we believe that a close-out requirement of thirty-five consecutive settlement days from settlement date for fails to deliver resulting from sales of equity securities sold pursuant to Rule 144, will permit the orderly settlement of such sales without the risk of causing market disruption due to unnecessary purchasing activity

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<sup>138</sup> See temporary Rule 204T(b)(1).

<sup>139</sup> See temporary Rule 204T(b)(2).

<sup>140</sup> See 17 CFR 242.200(a).

<sup>141</sup> As mentioned above, we recently adopted amendments to the close-out requirement of Regulation SHO to allow fails to deliver resulting from sales of threshold securities pursuant to Rule 144 to be closed out within 35 rather than 13 consecutive settlement days. See 2007 Regulation SHO Final Amendments, 72 FR at 45550-45551.

(particularly if the purchases are for sizable quantities of stock). Because the Rule 144 security sold will be received as soon as all processing delays have been removed, this additional time will allow participants to close out fails to deliver resulting from the sale of the security with the security sold, rather than having to close out such fail to deliver position by purchasing securities in the market. Thus, the amendments will reduce costs to participants and, in turn, investors.

Although the temporary rule allows fails to deliver resulting from sales of equity securities sold pursuant to Rule 144 of the Securities Act thirty-five consecutive settlement days after the settlement date before a participant must take action to close out the fail to deliver position, these fails to deliver must be closed out by no later than the beginning of regular trading hours on the thirty-sixth settlement day and, therefore, these fails to deliver cannot continue indefinitely. Thus, we believe that the temporary rule is consistent with our goal of further reducing fails to deliver in equity securities, while balancing the concerns associated with closing out fails to deliver resulting from sales of securities pursuant to Rule 144 of the Securities Act.

### **C. Costs**

We recognize that the temporary rule may result in increased short selling costs for participants that may impact legitimate short selling activities; however, we believe such costs will be limited. For example, it might result in participants incurring borrowing costs where they borrow securities to close out a fail to deliver position that might have been closed out soon thereafter with shares received from the customer. Such actions might result in added demand in the lending market which in turn might exert upward pressure on securities lending rates, potentially making short selling more expensive for all market participants. For example, it is estimated that about \$700 billion in U.S. equity securities are lent out per year. Preliminary input from industry participants suggests that lending rates increased significantly after the

September Emergency Order for stocks not covered by the ban on short selling. While results from the period after the September Emergency Order may be confounded by the unusual circumstances of the continued credit crisis, an increase of 10 basis points in lending rates would result in an annual cost increase to securities borrowers of \$700 million and the new revenue for securities lenders increasing by the corresponding amount of \$700 million. Therefore, if lending increased by 10 basis points, the annual impact on the securities lending market would be about \$1,400 million (or \$1,050 million for nine months).

To the extent that the requirements of the temporary rule will result in increased costs to short selling in equity securities, it may lessen some of the benefits of legitimate short selling and, thereby, result in a reduction in short selling generally. Such a reduction may lead to a decrease in market efficiency and price discovery, less protection against upward stock price manipulations, a less efficient allocation of capital, an increase in trading costs, and a decrease in liquidity. We also recognize that requiring that participants purchase securities to close out fails to deliver in equity securities in accordance with the temporary rule, may potentially impact the willingness of participants to provide liquidity.

As a likely result of the temporary rule as contained in the September Emergency Order, bid-ask spreads on equity securities have increased. Preliminary input from industry participants suggests that bid-ask spreads have increased after the September Emergency Order for stocks not covered by the ban on short selling. While results from the period after the September Emergency Order may be confounded by the unusual circumstances of the continued credit crisis, an increase of 1 basis point in bid-ask spreads would result in an annual cost to investors of about \$6,048 million. To calculate the annual cost, we assume that 12 billion shares trade on a daily basis. At an average share price of approximately \$20, this constitutes \$240 billion in

dollar volume per day. Based on this total, an increase in transaction costs of one basis point would result in a daily increase in realized transaction costs of approximately \$24 million a day. At this rate, investors would experience increased total transaction costs of over \$100 million within the first five trading days of the rule or about \$6,048 million annually (\$24 million times 252 trading days) (or \$4,536 million for nine months).

We believe, however, that strengthening rules against potentially abusive “naked” short selling will provide increased confidence in the securities markets. Thus, although we recognize that the temporary rule may result in increased short selling costs, we believe such costs are justified by the fact that the temporary rule may help restore, maintain, and enhance investor confidence in the markets by preventing potentially abusive “naked” short selling.

#### **1. Close-Out Requirements**

We also recognize that requiring that participants purchase securities to close-out fails to deliver in any equity security in accordance with the temporary rule, may potentially impact the willingness of participants to provide liquidity. However, we believe that any such potential effect will be minimal because participants will still have some flexibility by having two additional settlement days in which to purchase securities to close-out their fail to deliver positions that either result from long sales or are attributable to bona fide market making activities by Market Makers.

In addition, we recognize that the temporary rule’s close-out requirement may result in some additional costs for participants of a registered clearing agency in terms of systems and surveillance modifications, as well as changes to processes and procedures. However, we believe any additional costs incurred in implementing temporary Rule 204T’s close-out requirement in terms of these modifications will be minimal. The close-out requirement of the temporary rule is

consistent with the current settlement practices and procedures and with the close-out requirement of Regulation SHO. For example, because most transactions settle by T+3, participants should already have in place policies and procedures to help ensure that delivery is being made by settlement date. Nevertheless, participants will incur costs for each close-out and these costs could accumulate to significant amounts over time and across participants.

Moreover, similar to the existing close-out requirement of Rule 203(b)(3) of Regulation SHO, the temporary rule is based on a participant's fail to deliver position at a registered clearing agency. As noted above, the NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter markets. The NSCC clears and settles trades through the CNS system, which nets the securities delivery and payment obligations of all of its members. The NSCC notifies its members of their securities delivery and payment obligations daily. Thus, because the temporary rule is based on a participant's fail to deliver position at a registered clearing agency, it is consistent with current settlement practices and procedures and with the Regulation SHO framework regarding delivery of securities.<sup>142</sup> As such, we anticipate that most participants will already have systems, processes and procedures in place in order to comply with the temporary rule's close-out requirements and, therefore, that any additional implementation costs associated with the temporary rule will be minimal.

In addition, to comply with Regulation SHO's close-out requirement when it became effective in January 2005, participants needed to modify their recordkeeping systems and surveillance mechanisms. Participants also should have retained and trained the necessary personnel to ensure compliance with the rule's close-out requirements. Thus, most of the infrastructure necessary to comply with the temporary rule's close-out requirement should

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<sup>142</sup> See 17 CFR 242.203(b)(3).

already be in place. Thus, we believe that any changes to personnel, computer hardware and software, recordkeeping or surveillance costs will be minimal.

We recognize that the requirements of temporary Rule 204T(a)(1) may also impose additional costs on participants of a registered clearing agency. As discussed above, under temporary Rule 204T(a)(1), a participant of a registered clearing agency that has a fail to deliver position at a registered clearing agency in an equity security and can demonstrate on its books and records that the fail to deliver position resulted from a long sale, will have until no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date to immediately close out the fail to deliver position by purchasing securities of like kind and quantity. Thus, to qualify for this additional time to close out a fail to deliver position, the temporary rule requires the participant to demonstrate on their books and records that the fail to deliver position resulted from a long sale.

This demonstration requirement may result in participants incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. For example, as discussed in detail in Section VII above, for purposes of the Paperwork Reduction Act, we estimate that it will take each participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to comply with the demonstration requirement of the temporary Rule 204T(a)(1). In addition, we estimate that the total annual hour burden per year for each participant subject to the documentation requirement will be 1,371 hours.

The allocation notification requirement of temporary Rule 204T(d) will impose costs on broker-dealers that have been allocated responsibility for the close-out requirement under the temporary rule. As discussed above, temporary Rule 204T(d) requires a broker or dealer that has been allocated a portion of a fail to deliver position that has not complied with the close-out



provisions under the temporary rule to notify the participant that it has become subject to the borrowing requirements of temporary Rule 204T(b). This notification requirement may result in broker-dealers incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. For example, as discussed in detail in Section VII, above, for purposes of the Paperwork Reduction Act, we estimate that it will take each broker-dealer no more than approximately 0.16 hours (10 minutes) to comply with the notification requirements of temporary Rule 204T(d). In addition, we estimate that the total annual hour burden per year for each broker-dealer subject to the notification requirement will be 71.0 hours.

We also recognize that the requirements of temporary Rule 204T(e) may impose additional costs on broker-dealers. As discussed above, temporary Rule 204T(e) allows a broker-dealer to obtain pre-fail credit if it purchases securities in accordance with the conditions specified in the temporary rule. To receive pre-fail credit, the temporary rule requires, among other things, that a broker-dealer demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is claiming credit.

This demonstration requirement may result in participants incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. For example, as discussed in detail in Section VII above, for purposes of the Paperwork Reduction Act, we estimate that it will take each broker-dealer no more than approximately 0.16 hours (10 minutes) to comply with the demonstration requirements of the temporary rule. In addition, we estimate that the total annual hour burden per year for each broker-dealer subject to the demonstration requirement will be 71.0 hours.

## 2. Borrowing Requirements

We believe that temporary Rule 204T's borrow requirements for fail to deliver positions that are not closed out in accordance with the temporary rule will result in limited, if any, implementation costs to participants of a registered clearing agency, and broker-dealers from which they receive trades for clearance and settlement. These entities must already comply with the borrow requirements of Rule 203(b)(3)(iv) of Regulation SHO if a fail to deliver position has not been closed out in accordance with Regulation SHO's mandatory close-out requirement. Accordingly, these entities should already have in place the personnel, recordkeeping, systems, and surveillance mechanisms necessary to comply with the temporary rule's borrow requirements. Nevertheless, we recognize that each pre-borrow will impose costs on participants, broker-dealers, and investors and these costs can accumulate to significant amounts if the borrow requirement is imposed often.

The pre-borrow notification requirement of temporary Rule 204T(c) will impose costs on participants of a registered clearing agency. Temporary Rule 204T(c) requires a participant to notify any broker or dealer from which it receives trades for clearance and settlement, including any market maker that would otherwise be entitled to rely on the exception provided in Rule 203(b)(2)(iii) of Regulation SHO,<sup>143</sup> (1) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of temporary Rule 204T(a), and (2) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.<sup>144</sup> This notification requirement may result in participants incurring costs related to

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<sup>143</sup> See 17 CFR 203(b)(2)(iii) (providing for an exception from the "locate" requirement for market makers engaged in bona fide market making in that security at the time of the short sale).

<sup>144</sup> See temporary Rule 204T(c).

personnel, recordkeeping, systems, and surveillance mechanisms. For example, as discussed in detail in Section VII, above, for purposes of the Paperwork Reduction Act, we estimate that it will take each participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to comply with the pre-borrow notification requirements of temporary Rule 204T(b). In addition, we estimate that the total annual hour burden per year for each participant subject to the notification requirement will be 2,016 hours.

Moreover, we believe any additional costs incurred in connection with the borrowing requirements of temporary Rule 204T(b) will be limited by the fact that if a participant becomes subject to the borrowing requirements of temporary Rule 204T(b), a broker-dealer that clears through the participant will not also be subject to the borrowing requirements of temporary Rule 204T(b) if the broker-dealer can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. This provision allows a broker-dealer to avoid the costs of being subject to the temporary rule's borrowing requirements, provided that the broker-dealer can demonstrate that it did not incur a fail to deliver position in the security on settlement date.

The certification requirement of temporary Rule 204T(b)(1) may impose some costs on broker-dealers having to demonstrate that it was not responsible for any part of the fail to deliver position of the participant. As discussed above, temporary Rule 204T(b)(1) requires the broker-dealer to timely certify to the participant that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or the broker-dealer is in compliance with the requirements set forth in the temporary rule's Pre-Fail Credit provision. This certification requirement may result in broker-dealers incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. For example, as discussed in detail in Section VII, above, for purposes of the

Paperwork Reduction Act, we estimate that it will take each broker-dealer no more than approximately 0.16 hours (10 minutes) to comply with the certification requirement of temporary Rule 204T(b)(1). In addition, we estimate that the total annual hour burden per year for each broker-dealer subject to the certification requirement will be 71.0 hours.

Any potential additional costs associated with the temporary borrowing requirements will be limited by the fact that the temporary rule's borrowing requirements will not apply to Market Makers, provided that the Market Maker can demonstrate that it does not have an open fail to deliver position at the time of any additional short sales. This allows Market Makers to facilitate customer orders in a fast moving market without possible delays and added costs associated with complying with the pre-borrow penalty provision of temporary Rule 204T(b).

The demonstration requirement of temporary Rule 204T(b)(2) may impose costs on Market Makers. This demonstration requirement may result in Market Makers incurring costs related to personnel, recordkeeping, systems, and surveillance mechanisms. For example, as discussed in detail in Section VII, above, for purposes of the Paperwork Reduction Act, we estimate that it will take each Market Maker no more than approximately 0.16 hours (10 minutes) to comply with the demonstration requirement of temporary Rule 204T(b)(2). In addition, we estimate that the total annual hour burden per year for each Market Maker subject to this demonstration requirement will be 604.8 hours.

### **3. Sales of Securities Pursuant to Rule 144**

Consistent with our statements in connection with our recent amendments to Regulation SHO in connection with closing out fails to deliver in threshold securities sold pursuant to Rule 144,<sup>145</sup> we do not believe the temporary rule's close-out requirement will impose any significant

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<sup>145</sup> See 2007 Regulation SHO Final Amendments, 72 FR at 45550-45551.

burden or cost on market participants. We believe that a close-out requirement of thirty-five consecutive settlement days from settlement date for fails to deliver resulting from sales of equity securities sold pursuant to Rule 144 will reduce costs by allowing participants of a registered clearing agency with a fail to deliver position additional time for delivery of these securities.

Participants may incur, however, some added costs for minor changes to their current systems to reflect the application of the temporary rule's close-out requirement to fails to deliver resulting from sales of all equity securities, rather than just threshold securities, sold pursuant to Rule 144 of the Securities Act.

#### **D. Request for Comment**

The Commission is sensitive to the costs and benefits of the temporary rule, and encourages commenters to discuss any additional costs or benefits beyond those discussed herein, as well as any reduction in costs. Commenters should provide analysis and data to support their views of the costs and benefits associated with the temporary rule.

- What, if any, additional benefits are involved in complying with the temporary rule?  
Should the temporary rule be modified in any way to increase the benefits of the temporary rule? If so, how?
- What, if any, additional costs are involved in complying with the temporary rule? What are the types of costs, and what are the amounts? Should the temporary rule be modified in any way to mitigate costs? If so, how?
- The temporary rule requires that participants of a registered clearing agency deliver securities by settlement date, or if the participants have not delivered shares by settlement date, borrow or purchase securities to close out the fail to deliver position by no later than

the beginning of regular trading hours on the settlement day following the day the participant incurred the fail to deliver position. What are the costs and benefits associated with purchasing versus borrowing securities to close out a fail to deliver position?

- What impact will the temporary rule have on borrowing costs? Please explain. What effect will the temporary rule have on the availability of equity securities for lending and borrowing?
- The temporary rule will allow a participant that has a fail to deliver position at a registered clearing agency in an equity security and can demonstrate that such fail to deliver position resulted from a long sale, two additional settlement days in which to close out that fail to deliver position by purchasing securities of like kind and quantity. What costs and benefits are associated with the long sale documentation requirement? Are there any operational or compliance concerns associated with this provision of the temporary rule?
- The temporary rule will allow a participant of a registered clearing agency two additional settlement days to close out any fail to deliver positions attributable to a Market Maker. What are the costs and benefits of allowing this additional time to close-out fails to deliver attributable to Market Makers? Are there any operational or compliance concerns associated with this provision of the temporary rule?
- Will the temporary rule create any additional implementation or operational costs associated with systems (including computer hardware and software), surveillance, procedural, recordkeeping, or personnel modifications?

- To comply with the temporary rule, will broker-dealers be required to purchase new systems or implement changes to existing systems? Will changes to existing systems be significant? What are the costs and benefits associated with acquiring new systems or making changes to existing systems? What, if any, changes will need to be made to existing records? What are the costs and benefits associated with any changes?
- Will there be any increases in staffing and associated overhead costs? What are the costs and benefits associated with hiring new staff or retraining existing staff? Will other resources need to be re-dedicated to comply with the temporary rule?
- How much, if any, will the temporary rule affect compliance costs for small, medium, and large broker-dealers (e.g., personnel or system changes)? We seek comment on the costs of compliance that may arise.
- We solicit comment on whether the costs will be incurred on a one-time or ongoing basis, as well as cost estimates. In addition, we seek comment as to whether the temporary rule will decrease any costs for any market participants. We seek comment about any other costs and cost reductions associated with the temporary rule.
- We recognize that the temporary rule may increase the costs of legitimate short selling and lessen some of the benefits of legitimate short selling, which, in turn, could result in a reduction of short selling. To what extent, if any, will the temporary rule impact legitimate short selling and market efficiency?
- The temporary rule does not allow any exceptions for fails to deliver due to mechanical aspects of corporate events, such as equity offers, including initial public offerings, and tender offers. Will the temporary rule cause any disruption to these corporate events? Can the costs of any disruption be quantified?

- What, if any, additional costs are involved in complying with the borrowing requirements under temporary Rule 204T(b)? What are the types of costs, and what are the amounts? Should the temporary rule be modified in any way to mitigate costs? If so, how? Are there any operational or compliance concerns associated with the borrowing requirements under temporary Rule 204T(b)?
- The temporary rule will allow a broker-dealer that clears through a participant that becomes subject to the borrowing requirements of temporary Rule 204T(b) to avoid being subject to the temporary rule's borrowing requirements if the broker-dealer can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. What costs and benefits are associated with the certification requirement? Are there any operational or compliance concerns associated with this provision of the temporary rule?
- Temporary Rule 204T(c) imposes a pre-borrow notification requirement on participants. Will such a notification requirement impose operational or systems costs on participants? What types of communication mechanisms do participants use to comply with this requirement of the temporary rule? What are the costs and benefits of this notification requirement?
- What, if any, additional costs are associated with extending the close-out requirement for Rule 144 securities? What are the types of costs, and what are the amounts? Who bears these costs? Should the exception be modified in any way to mitigate costs? If so, how?
- Please identify any other costs, including reductions in costs, associated with sales of Rule 144 restricted securities not already discussed.



## **IX. Consideration of Burden on Competition and Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act requires the Commission, whenever it engages in rulemaking and whenever it is required to consider or determine if an action is necessary or appropriate in the public interest, to consider whether the action would promote efficiency, competition, and capital formation.<sup>146</sup> In addition, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.<sup>147</sup> Exchange Act Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act.

We believe the temporary rule will have minimal impact on the promotion of efficiency. The temporary rule is intended to further reduce fails to deliver and address abusive “naked” short selling in equity securities by requiring that participants of a registered clearing agency deliver securities by settlement date, or if the participants have not delivered shares by settlement date, the participants must, by no later than the beginning of regular trading hours on the Close-Out Date, immediately close out the fail to deliver position by borrowing or purchasing securities of like kind and quantity. A participant that does not comply with this close-out requirement, and any broker-dealer from which it receives trades for clearance and settlement, will not be able to short sell the security either for itself or for the account of another, unless it has first arranged to borrow the security, until the fail to deliver position is closed out.

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<sup>146</sup> 15 U.S.C. 78c(f).

<sup>147</sup> 15 U.S.C. 78w(a)(2).

The temporary rule is designed to ensure that buyers of equity securities receive delivery of their shares, thereby helping to reduce persistent fails to deliver, which may have a negative effect on the securities markets and investors and also may be used to facilitate some manipulative strategies. By requiring that participants of a registered clearing agency deliver securities by settlement date and to the extent that participants have not delivered shares by settlement date, borrow or purchase securities to close out the fail to deliver position by no later than the beginning of regular trading hours on the Close-Out Date, the temporary rule will promote the prompt clearance and settlement of securities transactions. By doing so, the temporary rule will further our goals of helping to eliminate any possibility that abusive “naked” short selling, as well as persistent fails to deliver, will contribute to the disruption of markets in equity securities and, thereby, will help ensure that investors remain confident that trading can be conducted without the illegal influence of manipulation. A loss of confidence in the market for these securities can lead to panic selling, which may be further exacerbated by potentially abusive “naked” short selling. As a result, prices of these securities may artificially and unnecessarily decline below the price level that would have resulted from the normal price discovery process, threatening the disruption of the markets for these securities. We seek comment regarding whether the temporary rule may adversely impact liquidity, disrupt markets, or unnecessarily increase risks or costs to participants of a registered clearing agency.

In addition, we believe that the temporary rule will have minimal impact on the promotion of capital formation. Issuers and investors have repeatedly expressed concerns about fails to deliver in connection with manipulative “naked” short selling.<sup>148</sup> The perception that abusive “naked” short selling is occurring in securities could undermine the confidence of

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<sup>148</sup> See, e.g., 2008 Regulation SHO Final Amendments, supra note 19.

investors. These investors, in turn, may be reluctant to commit capital to an issuer they believe to be subject to such manipulative conduct.<sup>149</sup> To the extent that “naked” short selling and fails to deliver result in an unwarranted decline in investor confidence about a security, the temporary rule will improve investor confidence about the security. In addition, the temporary rule may lead to a greater certainty in the settlement of these securities which should strengthen investor confidence in the settlement process

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

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<sup>149</sup> In connection with prior proposed amendments to Regulation SHO aimed at reducing fails to deliver and addressing potentially abusive “naked” short selling, such as the 2007 Regulation SHO Proposed Amendments, we sought comment on whether such proposed amendments would promote capital formation, including whether the proposed increased short sale restrictions would affect investors’ decisions to invest in certain equity securities. In response, commenters expressed concern about the potential impact of “naked” short selling on capital formation claiming that “naked” short selling causes a drop in an issuer’s stock price that may limit the issuer’s ability to access the capital markets. See, e.g., letter from Robert K. Lifton, Chairman and CEO, Medis Technologies, Inc., dated Sept. 12, 2007; letter from NCANS.

temporary rule will help to maintain fair and orderly markets without unduly restricting legitimate short selling.

In addition, by providing a close-out requirement of 35 consecutive settlement days from settlement date for fails to deliver resulting from sales of equity securities sold pursuant to Rule 144 of the Securities Act, we believe the temporary rule will promote competition by requiring similarly situated participants to close out fail to deliver positions in any equity securities resulting from sales of Rule 144 securities within the same time-frame.

Similarly, an extended close-out requirement for fails to deliver resulting from long sales that are attributable to a Market Maker, will promote competition by requiring similarly situated participants to close out these fail to deliver positions within the same time-frame.

We request comment on whether the temporary rule is likely to promote efficiency, capital formation, and competition.

## **X. Final Regulatory Flexibility Analysis**

The Final Regulatory Flexibility Analysis (“FRFA”) has been prepared in accordance with 5 U.S.C. 604. This FRFA relates to the amendments that add temporary Rule 204T to Regulation SHO, which we are adopting in this release.<sup>150</sup>

### **A. Need for and Objectives of the Rule**

Sections I through VI of this release describe the reasons for and objectives of temporary Rule 204T. As we discuss in detail above, we have become concerned that there is a substantial threat of sudden and excessive fluctuations of securities prices and disruption in the functioning of the securities markets that could threaten fair and orderly markets.

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<sup>150</sup> Although the requirements of the Regulatory Flexibility Act are not applicable to rules adopted under the Administrative Procedure Act’s “good cause” exception, see 5 U.S.C. 601(2) (defining “rule” and notice requirements under the Administrative Procedures Act), we nevertheless prepared a FRFA.

## **B. Small Entities Affected by the Rule**

The entities covered by the temporary rule will include small entities that are participants of a registered clearing agency and small broker-dealers from which participants receive trades for clearance and settlement. In addition, the entities covered by the temporary rule will include small entities that are market participants that effect sales subject to the requirements of Regulation SHO. Although it is impossible to quantify every type of small entity covered by the temporary rule, Paragraph (c)(1) of Rule 0-10 under the Exchange Act<sup>151</sup> states that the term “small business” or “small organization,” when referring to a broker-dealer, means a broker or dealer that had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date in the prior fiscal year as of which its audited financial statements were prepared pursuant to §240.17a-5(d); and is not affiliated with any person (other than a natural person) that is not a small business or small organization. We estimate that as of 2007 there were approximately 896 broker-dealers that qualified as small entities as defined above.<sup>152</sup>

As noted above, the entities covered by the temporary rule will include small entities that are participants of a registered clearing agency. As of July 31, 2008, approximately 91% of participants of the NSCC, the primary registered clearing agency responsible for clearing U.S. transactions, were registered as broker-dealers. Participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that would implicate the close-out requirements of Regulation SHO. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in

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<sup>151</sup> 17 CFR 240.0-10(c)(1).

<sup>152</sup> These numbers are based on OEA’s review of 2007 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.

municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually cleaned up within a day. Thus, such fails to deliver would not trigger the close-out provisions of Regulation SHO.

The federal securities laws do not define what is a "small business" or "small organization" when referring to a bank. The Small Business Administration regulations define "small entities" to include banks and savings associations with total assets of \$165 million or less.<sup>153</sup> As of July 31, 2008, no bank that was a participant of the NSCC was a small entity because none met these criteria.

Paragraph (e) of Rule 0-10 under the Exchange Act<sup>154</sup> states that the term "small business" or "small organization," when referring to an exchange, means any exchange that: (1) has been exempted from the reporting requirements of Rule 11Aa3-1 under the Exchange Act; and (2) is not affiliated with any person (other than a natural person) that is not a small business or small organization, as defined by Rule 0-10. No U.S. registered exchange is a small entity because none meets these criteria.

Paragraph (d) of Rule 0-10 under the Exchange Act<sup>155</sup> states that the term "small business" or "small organization," when referring to a clearing agency, means a clearing agency that: (1) compared, cleared and settled less than \$500 million in securities transactions during the preceding fiscal year (or in the time that it has been in business, if shorter); (2) had less than \$200 million in funds and securities in its custody or control at all times during the preceding

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<sup>153</sup> See 13 CFR 121.201.

<sup>154</sup> 17 CFR 240.0-10(e).

<sup>155</sup> 17 CFR 240.0-10(d).

fiscal year (or in the time that it has been in business, if shorter); and (3) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined by Rule 0-10. No clearing agency that is subject to the requirements of Regulation SHO is a small entity because none meets these criteria.

**C. Projected Reporting, Recordkeeping and Other Compliance Requirements**

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

**D. Agency Action to Minimize Effect on Small Entities**

As required by the Regulatory Flexibility Act, we have considered alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. Temporary Rule 204T should not adversely affect small entities because it imposes minimal new reporting, record keeping, or compliance requirements. Moreover, it is not appropriate to develop separate requirements for small entities because we think all small entities that are broker-dealers, should be subject to the enhanced delivery requirements imposed by the temporary rule.

**E. Duplicative, Overlapping, or Conflicting Federal Rules**

The Commission believes that there are no rules that duplicate, overlap, or conflict with temporary Rule 204T. The Commission has designed the temporary rule so that it is consistent with the close-out requirements of Rule 203(b)(3) of Regulation SHO.

## **F. Significant Alternatives**

The Regulatory Flexibility Act directs us to consider significant alternatives that would accomplish our stated objective, while minimizing any significant adverse impact on small entities.<sup>156</sup> In connection with the temporary rule, we considered the following alternatives: (1) Establishing different compliance or reporting standards or timetable that take into account the resources available to small entities; (2) clarifying, consolidating, or simplifying compliance requirements under the rule for small entities; (3) using performance rather than design standards; and (4) exempting small entities from coverage of the rule, or any part of the rule.

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

The temporary rule should not adversely affect small entities because the rule may impose only minimal new compliance requirements. Moreover, it is not appropriate to develop different compliance requirements for small entities with respect to the temporary rule because we think all entities, including small entities, should be subject to the requirements of the temporary rule. We believe that imposing different compliance requirements, and possibly a different timetable for implementing compliance requirements, for small entities would undermine the Commission's goal of addressing abusive "naked" short selling. We have

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<sup>156</sup> See 5 U.S.C. 603(c).



concluded similarly that it is not consistent with the goal of the temporary rule to further clarify, consolidate or simplify the temporary rule for small entities. The Commission also believes that it is inconsistent with the purposes of the Exchange Act to use performance standards to specify different requirements for small entities or to exempt small entities from having to comply with the temporary rule.

### **G. General Request for Comments**

We solicit written comments regarding our analysis. We request comment on whether the temporary rule will have any effects that we have not discussed. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

### **XI. Statutory Authority**

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 6, 9(h), 10, 11A, 15, 15A, 17, 17A, 19 and 23(a) thereof, 15 U.S.C. 78b, 78c(b), 78f, 78i(h), 78j, 78k-1, 78o, 78o-3, 78q, 78q-1, 78s and 78w(a), the Commission is adopting, as an interim final temporary rule, Rule 204T, amendments to Regulation SHO.

### **XII. Text of the Amendments to Regulation SHO**

#### **List of Subjects**

17 CFR Part 242

Brokers, Fraud, Reporting and recordkeeping requirements, Securities.

For the reasons set out in the preamble, Title 17, Chapter II, Part 242, of the Code of Federal Regulations is amended as follows.

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

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

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

2. Section 242.204T is added to read as follows:

**§ 242.204T Short sales.**

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

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

(2) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security sold pursuant to § 230.144 of this chapter for thirty-five consecutive settlement days after the settlement date for a sale in that equity security, the participant shall, by no later than the beginning of regular trading hours on the thirty-sixth

consecutive settlement day following the settlement date for the transaction, immediately close out the fail to deliver position by purchasing securities of like kind and quantity; or

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

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

(1) A broker or dealer shall not be subject to the requirements of paragraph (b) of this section if the broker or dealer timely certifies to the participant of a registered clearing agency that it has not incurred a fail to deliver position on settlement date for a long or short sale in an

equity security for which the participant has a fail to deliver position at a registered clearing agency or that the broker or dealer is in compliance with paragraph (e) of this section.

(2) The requirements of paragraph (b) of this section shall not apply to Market Makers provided the Market Maker can demonstrate that it does not have an open short position in the equity security at the time of any additional short sales.

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

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

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

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

(e) Even if a participant of a registered clearing agency has not closed out a fail to deliver position at a registered clearing agency in accordance with paragraph (a) of this section, or has

not allocated a fail to deliver position to a broker or dealer in accordance with paragraph (d) of this section, a broker or dealer shall not be subject to the requirements of paragraph (a) or (b) of this section if the broker or dealer purchases securities prior to the beginning of regular trading hours on the settlement day after the settlement date for a long or short sale to close out an open short position, and if:

(1) The purchase is bona fide;

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

(3) The purchase is of a quantity of securities sufficient to cover the entire amount of the open short position; and

(4) The broker or dealer can demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is seeking to demonstrate that it has purchased shares to close out its open short position.

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

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

(g) This temporary section will expire and no longer be effective on July 31, 2009.

By the Commission.

Florence E. Harmon  
Acting Secretary

Dated: October 14, 2008