

## Regulators Provide “Tips” for Broker-Dealers on Avoiding Failures to Deliver Securities

The Staff of the SEC’s Division of Trading and Markets and the Office of Compliance Inspections and Examinations, along with FINRA and NYSE are providing the following information to assist broker-dealer firms in preventing failures to deliver securities. Firms conducting short sales are encouraged to consider practices to prevent delivery failures, including, for example:

- *Borrowing.* Borrowing and obtaining control of the securities before settlement, rather than entering into an agreement to borrow such securities. One firm, for example, has indicated that it has made a practice of borrowing or maintaining adequate inventory to allow it to deliver securities by settlement date and thereby prevent a fail to deliver in that security.
- *Arrangement to borrow.* Entering into an agreement to borrow securities, especially in transactions in hard-to-borrow securities, in order to ensure that the firm will be able to settle the transaction on T + 3. This practice provides assurance that the shares will be available upon settlement and that the trade will not fail.
- *Earmarking.* If the firm enters into an arrangement to pre-borrow shares without obtaining control, determining that the source of shares for the pre-borrow will be available on T + 3. Shares may be specifically earmarked for each arrangement to borrow.
- *Maintaining an inventory.* Maintaining adequate inventory of securities in which the firm frequently executes short sales sufficient to cover anticipated short sales and to cover any pre-borrows granted by the firm. Reducing the shares available from inventory in order to ensure that adequate shares are available to deliver by settlement date.
- *Documenting the source of shares.* In instances where a customer relies on a broker-dealer other than the executing broker-dealer to settle a transaction, the broker-dealer that settles the customer’s transaction documents the source of the customer’s pre-borrow. Additionally, the executing broker-dealer has adequate controls in place to ensure that locates or pre-borrow arrangements provided by the customer are valid. In addition, executing broker-dealers are reminded that when a customer provides assurance that it has access to shares to settle their transaction, the executing broker-dealer is required to document the source of the customer’s pre-borrow.
- *Monitoring locates.* Monitoring the performance of the locates provided by customers to assess future reliability.

- *Encouraging timely affirmations.* Working with institutional clients to encourage the development of efficient systems for confirmation and affirmation of trades, to assure timely delivery of DVP trades.
- *Direct market access/sponsored access.* Firms may also want to consider the practices outlined here in conjunction with their policies and procedures regarding short sales entered via direct market access or sponsored participant arrangements. Document the source of pre-borrowed shares when a short sale transaction is entered via a direct market access and/or other sponsored access arrangements.

Firms are reminded that they must maintain adequate surveillances and written supervisory procedures to detect manipulative short selling activity and activity that is violative of the Commission's rules.

These "tips" are intended to assist broker-dealer firms in establishing policies and procedures and controls to avoid failures to deliver. They are not required practices, and other practices may be effective as well. Regulators will also monitor for compliance with the SEC's new rules to protect investors against naked short selling abuses, effective Thursday September 18, 2008 (<http://www.sec.gov/news/press/2008/2008-204.htm>).