



DIVISION OF  
TRADING AND MARKETS

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

October 27, 2014

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

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

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Dear Ms. Stekler:

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

To meet its close-out obligation under Rule 204, a Participant must be able to demonstrate on its books and records that on the applicable close-out date it purchased or borrowed shares in the full quantity of its fail to deliver and, therefore, that the Participant has a net flat or net long position on its books and records on the applicable close-out date (*i.e.*, during T+4 or T+6, as applicable).<sup>1</sup> The quantity of a Participant’s close-out requirement under Rule 204 is based on a Participant’s fail to deliver position at a registered clearing agency.<sup>2</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

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<sup>1</sup> 17 CFR 242.204(a); Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266, 38272 (July 31, 2009) (“Rule 204 Adopting Release”). Generally, investors settle their transactions in most exchange-traded securities within three settlement days, known as T+3. T+3 means that, when a trade occurs, the participants in the trade deliver and pay for the security at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange the funds for the securities on that third settlement day. References throughout this letter to T+ “day” assume a settlement cycle of trade date plus three days. If the financial industry transitioned to a shortened settlement cycle, for example, to trade date plus one or two days, all references to T+ “day” in this letter should be reinterpreted accordingly. *See, e.g., Cost Benefit Analysis of Shortening the Settlement Cycle*, prepared by the Boston Consulting Group, commissioned by the Depository Trust and Clearing Corporation, Oct. 2012, available at [http://www.dtcc.com/downloads/leadership/whitepapers/BCG\\_2012.pdf?n=59408](http://www.dtcc.com/downloads/leadership/whitepapers/BCG_2012.pdf?n=59408).

<sup>2</sup> *See id.* The National Securities Clearing Corporation (“NSCC”) clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter markets. NSCC clears and settles trades through the Continuous Net Settlement (“CNS”) system, which nets the securities delivery and payment obligations of all of its members. NSCC notifies its members of their securities delivery and payment obligations daily. *See* Rule 204 Adopting Release, 74 FR at 38268 n.35.

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

The Commission further specified that where a Participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the Participant's fail position, and for which the Participant is unable to demonstrate a legitimate economic purpose, the Participant will not be deemed to have satisfied the close-out requirement.<sup>4</sup> Sales with a legitimate economic purpose are not an exception to the requirement to purchase or borrow the full quantity of the fail to deliver and, therefore, have a net flat or net long position on the applicable close-out date.<sup>5</sup> Thus, if a Participant cannot demonstrate that it has a net flat or net long position on its books and records on the applicable close-out date, the Participant has not met its close-out obligation, regardless of whether sales on that day had a legitimate economic purpose.

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

Notwithstanding the strict close-out requirements of Rule 204,<sup>6</sup> you describe in your letter a proposed approach to addressing the Commission's policy goal of reducing fails to deliver,<sup>7</sup> and, specifically, the concern that subsequent activity on the date of a Rule 204 close out may serve to re-establish a short position and thus potentially extend a CNS fail to deliver. Specifically, you represent that GSEC will establish, maintain and enforce certain written policies and procedures, described in detail in your letter, that are reasonably designed to address certain subsequent trading activity<sup>8</sup> on a Rule 204 close-out date (the "NFNL Approach").

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

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<sup>3</sup> See Rule 204 Adopting Release, 74 FR at 38272 n.81.

<sup>4</sup> See *id.* at 38272 n.82.

<sup>5</sup> See *id.* ("In addition, where a participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the participant's fail, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement.").

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

<sup>7</sup> See Rule 204 Adopting Release, 74 FR at 38267, 38276.

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

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

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

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

Based on the foregoing and the facts and representations set forth in your letter, the Division would not recommend to the Commission enforcement action under Rule 204 regarding subsequent activity on the date that GSEC effects a close-out if GSEC complies with Rule 204 consistent with the NFNL Approach<sup>10</sup> and, in particular, the representations that:

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

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

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

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



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

3. GSEC will identify the Clients that caused or contributed to the firm's net fail to deliver to CNS and determine the number of shares attributable to each such Client using a reasonably designed and consistently applied method, taking into account the trade date net trading activity and the net short position of each Client. GSEC will not attribute fails to deliver in a manner designed to create an unfair advantage for a particular Client, allocated broker-dealer or GSEC.
4. GSEC understands that the identification of and notification to Clients<sup>12</sup> that caused or contributed to GSEC's net fail to deliver to CNS as described in your letter is not an allocation under Rule 204(d) and that, as such, GSEC does not transfer legal responsibility for complying with Rule 204 to such Clients.
5. If GSEC detects that a Covered Client has engaged in a pattern of trading activity that could be used to re-establish the Covered Client's short position and thus potentially extend GSEC's fail to deliver to CNS, GSEC will escalate issues relating to such conduct to GSEC's Compliance Department, which, in conjunction with other appropriate GSEC personnel, will determine whether any other action should be taken in light of all relevant facts and circumstances.<sup>13</sup>
6. To the extent that GSEC commits its own capital to purchase the shares (rather than assigning the economic cost to Clients), GSEC represents that its firm accounts will end the day on the close-out date as a "net purchaser" of a number of shares of the relevant security at least equal to the amount of the fail to deliver position closed-out by the firm accounts.
7. GSEC recognizes that, to satisfy its Rule 204 close-out obligation, in whole or in part, by borrowing shares, GSEC must borrow<sup>14</sup> shares by no later than the beginning of regular trading hours on the morning of a Rule 204 close-out date. To the extent that all or a portion of GSEC's Rule 204 obligation has not been satisfied (by borrowing or otherwise) by the beginning of regular trading hours on the morning of the Rule 204 close-out date, GSEC will purchase shares to satisfy its Rule 204 close-out obligation and will apply the NFNL Approach to such purchases.
8. Securities in which GSEC has a Rule 204 close-out obligation will not appear on the ETB list for the applicable close-out date and, accordingly, GSEC will not utilize the ETB list to grant locates for such securities on the applicable close-out date.
9. GSEC will make and keep accurate books and records as required by the federal securities laws, including books and records sufficient to demonstrate that GSEC is following the terms of the NFNL Approach as described in your letter, and will promptly provide such records to the Commission upon request.

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

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

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

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

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

Sincerely,



Josephine J. Tao  
Assistant Director

Attachment

cc: Valerie Dahiya  
Special Counsel

Beth A. Stekler

+1 202 663 6588 (t)  
+1 202 663 6363 (f)  
beth.stekler@wilmerhale.com

October 27, 2014

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

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

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Dear Ms. Tao:

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

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

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

<sup>3</sup> *Id.*

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### Regulation SHO Close-Out Requirements Under Rule 204

Under Rule 204, a participant of a registered clearing agency<sup>4</sup> (“Participant”) must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or must close out a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity.<sup>5</sup> The Participant must close out a fail to deliver for a short sale transaction by no later than the beginning of regular trading hours<sup>6</sup> on the settlement day following the settlement date, referred to as T+4.<sup>7</sup> If a Participant has a fail to deliver that the Participant can demonstrate on its books and records has resulted from a long sale, or is attributable to *bona fide* market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the Participant must close out the fail to deliver position by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, referred to as T+6.<sup>8</sup>

In its Rule 204 Adopting Release, the Commission stated that, to meet the close-out obligation, a Participant also must be able to demonstrate on its books and records that, on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position and, therefore, that the Participant has a net flat or net long position on its books and records on the applicable close-out date (*i.e.*, T+4 or T+6, as applicable).<sup>9</sup> Footnote 82 of the Rule 204 Adopting Release provides that, in addition, where a Participant subject to the close-out requirement purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the Participant’s fail position, and for which the Participant is unable to demonstrate a legitimate economic purpose, the Participant will not be deemed to have satisfied the close-out requirement.<sup>10</sup>

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

<sup>5</sup> 17 CFR 242.204(a).

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

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

<sup>8</sup> 17 CFR 242.204(a)(1) and (a)(3).

<sup>9</sup> *See* Rule 204 Adopting Release, 74 FR at 38272.

<sup>10</sup> *See id.* at 38272 n.82.

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

### **Operational and Practical Difficulties**

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

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

### **Proposed Approach To Close-out Date Activity**

GSEC takes its obligation to comply with Rule 204 seriously and respects the Commission's concern regarding fails to deliver and the important role that Rule 204 plays in efforts by the Commission to address fails. In an effort to address some of the operational and practical difficulties discussed above, GSEC has made changes to its Rule 204 methodology to reasonably allocate close-out responsibility to market maker broker-dealers<sup>14</sup> for which GSEC

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

<sup>12</sup> 17 CFR 242.204(b).

<sup>13</sup> *See id.* at n.11.

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



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

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

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

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

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

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

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

As part of the New Approach, to the extent that GSEC purchases<sup>22</sup> shares to satisfy its Rule 204 obligation in a security and, based on the aforementioned attribution methodology,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

Sincerely,



Beth A. Stekler