



DIVISION OF  
TRADING AND MARKETS

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

September 6, 2013

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Financial Industry Regulatory Authority, Inc.  
1735 K St., NW  
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Timothy H. Thompson  
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Chicago Board Options Exchange, Incorporated  
C2 Options Exchange, Incorporated  
400 South LaSalle St.  
Chicago, IL 60605

Re: Request for No-Action Relief with Respect to Multi-day Pre-fail and Post-fail  
Credit under Rule 204 of Regulation SHO  
TP File No. 13-11

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Dear Messrs. Colby and Thompson:

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

To meet its close-out obligation under Rule 204, a Participant must be able to demonstrate on its books and records that on the applicable close-out date it purchased or borrowed shares in the full quantity of its fail to deliver and, therefore, that the Participant has a net flat or net long position on its books and records on the applicable close-out date (*i.e.*, during

T+4 or T+6, as applicable).<sup>1</sup> Thus, in establishing the strict close out requirements of Rule 204, the Commission specified that the full quantity of the fail to deliver must be purchased or borrowed on “the applicable close-out date,” which it referenced in the singular, as either T+4 or T+6.<sup>2</sup> Similarly, a Broker-Dealer may only claim Pre-fail Credit in the limited circumstances where a *bona-fide* purchase or borrow for the entire amount of its fail to deliver<sup>3</sup> is effected by that Broker-Dealer on a day that is one of T+1, T+2 or T+3,<sup>4</sup> and the Broker-Dealer can demonstrate on its books and records that it has a net flat or net long position for that same day.<sup>5</sup>

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

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

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<sup>1</sup> 17 CFR 242.204(a); Rule 204 Adopting Release, 74 FR at 38272. Generally, investors settle their transactions in most exchange-traded securities within three settlement days, known as T+3 (or “trade date plus three days”). T+3 means that when a trade occurs, the participants to the trade deliver and pay for the security at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange the funds for the securities on that third settlement day. The date on which a Broker-Dealer must close out a fail to deliver pursuant to Rule 204 does not affect the security’s settlement date nor extend the timing of delivery obligations for that security. *See* Rule 204 Adopting Release, 74 FR at 38267 n. 16. If a failure to deliver is not closed out as required by Rule 204, it is a violation of Rule 204. *See* Rule 204 Adopting Release, 74 FR at 38266. References throughout this letter to T+ “day” assume a settlement cycle of trade date plus three days. If the financial industry transitioned to a shortened settlement cycle, for example, to trade date plus one or two days, all references to T+ “day” in this letter should be adjusted accordingly. *See, e.g., Cost Benefit Analysis of Shortening the Settlement Cycle*, prepared by the Boston Consulting Group, commissioned by the Depository Trust and Clearing Corporation, Oct. 2012, available at [http://www.dtcc.com/downloads/leadership/whitepapers/BCG\\_2012.pdf?n=59408](http://www.dtcc.com/downloads/leadership/whitepapers/BCG_2012.pdf?n=59408).

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

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

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

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

<sup>6</sup> *See* Rule 204 Adopting Release, 74 FR at 38267, 38276.

<sup>7</sup> *See* 17 CFR 242.204(e).

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

3. Fails related to sales resulting from options exercises or assignments must be closed out in accordance with Rule 204.<sup>9</sup>
4. Consistent with Rule 204(d), Participants using Allocation with the Multi-day Approach would reasonably Allocate fails using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Allocated Broker-Dealer.<sup>10</sup> A Participant that Allocates a fail to deliver must ensure that the notice is clear as to the quantity of the fail being Allocated and that an Allocation of a fail is being made under Rule 204(d) such that upon Allocation, all obligations under Rule 204(a) and 204(b) rest solely with the Allocated Broker-Dealer.<sup>11</sup>
5. In the absence of a Rule 204(d) Allocation, the Penalty Box, if triggered, applies to both the Participant and its Correspondents, in each case on a firm-wide basis. In the absence of an Allocation, a Participant may not apply the Penalty Box only to a Correspondent, a customer, or an account or aggregation unit of a Correspondent or customer, to which the Participant determines to pass on the costs of a buy-in.<sup>12</sup>

Based on the foregoing, the Division would not recommend to the Commission enforcement action under Section 19(g)(1) of the Exchange Act<sup>13</sup> if FINRA and the Exchanges enforce Rule 204 consistent with the Multi-day Approach,<sup>14</sup> or if Broker-Dealers use the Multi-day Approach in connection with their regulatory obligations under Rule 204, on the basis of the

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

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

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

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

<sup>13</sup> 15 U.S.C. 78s(g).

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

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

1. The Multi-day Approach would not apply to the requirements to satisfy a close-out obligation on the applicable close-out date (*i.e.*, T+4 or T+6),<sup>15</sup> except to the extent that the amount of the close-out obligation to be met on the applicable close-out date could be reduced by claiming Credit using the Multi-day Approach based on net purchases prior to the applicable close-out date.
2. Credit would only be claimed for days on which the Broker-Dealer can demonstrate on its books and records that it has net purchases for the day, calculated based on the entirety of the Broker-Dealer's *bona fide* trading activity,<sup>16</sup> and in no case would a Broker-Dealer claim Credit for purchases on a day on which its trading activity results in a net sale position, regardless of whether sales executed on that day had a legitimate economic purpose.
3. The Multi-day Approach would be applied in a manner that avoids double-counting net purchases, or purchases for compliance with a close-out date (*i.e.*, T+4 or T+6) requirement. Reliance on the NSCC net delivery obligation under footnote 81 of the Rule 204 Adopting Release<sup>17</sup> would be applied in a manner that avoids double-counting of multi-day activity claimed for Credit.
4. A Participant using Attribution with the Multi-day Approach would reasonably Attribute fails to each Correspondent using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Correspondent. Consistent with Rule 204(d), a Participant using Allocation with the Multi-day Approach would reasonably Allocate fails using a consistently applied method designed to resolve fails to deliver, taking into account the trade date net trading activity and net short position of the Allocated Broker-Dealer.<sup>18</sup>
5. The same reasonableness standard applicable to Attribution under the Multi-day Approach would apply to Allocation under the Multi-day Approach. It would not be reasonable to Attribute fails to Correspondents or to Allocate fails to Allocated Broker-Dealers in a manner designed to create an advantage for a particular Correspondent, Allocated Broker-Dealer or the Participant by reducing the fail to deliver amount Attributed to the Correspondent or the fail to deliver amount for which the Allocated Broker-Dealer or Participant is responsible,

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

<sup>16</sup> The same standard for "*bona fide*" used under Rule 204(e)(1) would continue to apply to the aggregate net purchase activity claimed by a Broker-Dealer for this purpose (*i.e.*, the purchase cannot be a sham close-out). For example, where a Broker-Dealer enters into an arrangement with another person to purchase or borrow securities, and the Broker-Dealer knows or has reason to know that the other person will not deliver securities in settlement of the transaction, the purchase or borrow will not be "*bona fide*." See 17 CFR 242.204(e)(1); Rule 204 Adopting Release, 74 FR at 38275-38276. See also *infra* note 20.

<sup>17</sup> Rule 204 Adopting Release, 74 FR at 38272 n. 81.

<sup>18</sup> See Rule 204 Adopting Release, 74 FR at 38273. Rule 204 does not, by its terms, apply to the allocation of costs by a Broker-Dealer in connection with meeting its close-out requirements. See Rule 204 Adopting Release, 74 FR at 38274 n. 102. The Participant or Allocated Broker-Dealer could pass on the economic cost of complying with its own Rule 204(a) obligation (*i.e.*, a buy-in) based on agreement or understandings with its Correspondents or customers.

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

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

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

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

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

<sup>21</sup> See, e.g., FINRA Rule 3130.

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

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

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

Sincerely,



Josephine J. Tao  
Assistant Director

Attachment

cc: Katrina G. Wilson  
Special Counsel



September 6, 2013

**By Email and Overnight Mail**

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

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

Dear Ms. Tao:

Financial Industry Regulatory Authority, Inc. (“FINRA”) and Chicago Board Options Exchange, Incorporated (“CBOE”) and C2 Options Exchange, Incorporated (together, “Exchanges”) respectfully jointly request that the staff of the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (“Commission”) provide assurances that it will not recommend to the Commission enforcement action if FINRA and the Exchanges enforce compliance with Rule 204 of Regulation SHO<sup>1</sup> consistent with an approach, as further described herein, that generally would permit a participant of a registered clearing agency<sup>2</sup> (“Participant”) or a registered broker-dealer from which a Participant receives trades for clearance and settlement (including introducing and executing brokers) (“Correspondents”) to which a Participant allocates a fail to deliver position pursuant to Rule 204(d) of Regulation SHO (an “Allocated Broker-Dealer”), to claim credit for closing out a fail to deliver position at a

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<sup>1</sup> 17 CFR 242.204.

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

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

## I. Background

Under Rule 204 of Regulation SHO (“Rule 204”), Participants must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or must close out a fail to deliver at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity.<sup>4</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>5</sup> on the settlement day following the settlement date, referred to as T+4.<sup>6</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 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>7</sup>

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

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

<sup>4</sup> 17 CFR 242.204(a).

<sup>5</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>6</sup> 17 CFR 242.204(a). Generally, investors settle their transactions in most exchange-traded securities within three settlement days, known as T+3 (or “trade date plus three days”). T+3 means that when a trade occurs, the participants to the trade deliver and pay for the securities at a clearing agency three settlement days after the trade is executed so the brokerage firm can exchange the funds for the securities on that third settlement day. The date on which a broker-dealer must close out a fail to deliver pursuant to Rule 204 does not affect the security’s settlement date nor extend the timing of the delivery obligations for that security. *See* Rule 204 Adopting Release, 74 FR at 38267 n. 16. If a fail to deliver is not closed out as required by Rule 204, it is a violation of Rule 204. *See* Rule 204 Adopting Release, 74 FR at 38266.

<sup>7</sup> 17 CFR 242.204(a)(1) and (a)(3).

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

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

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

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<sup>8</sup> Rule 204 Adopting Release, 74 FR at 38272.

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

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

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

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

<sup>14</sup> *Id.*

deliver<sup>15</sup> is effected by that broker-dealer on a single day that is either T+1, T+2 or T+3,<sup>16</sup> and the broker-dealer can demonstrate on its books and records that it has a net flat or net long position on such day.<sup>17</sup>

Further, footnote 81 of the Rule 204 Adopting Release provides that, in determining the amount of its close-out obligation, a Participant may rely on its net delivery obligation as reflected in its notification from the National Securities Clearing Corporation (“NSCC”)<sup>18</sup> regarding its securities delivery and payment obligations, provided such notification is received prior to the beginning of regular trading hours on the applicable close-out date (*i.e.*, T+4 or T+6).<sup>19</sup>

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

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

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

<sup>18</sup> The majority of equity trades in the U.S. are cleared and settled through systems administered by clearing agencies registered with the Commission. NSCC clears and settles the majority of equity securities trades conducted on the exchanges and in the over-the-counter market. NSCC clears and settles trades through the Continuous Net Settlement (“CNS”) system, which nets the securities delivery and payment obligations of all of its members. The T+3 settlement cycle is the standard settlement cycle for any security traded on a U.S. exchange and cleared through the NSCC’s CNS system. NSCC notifies its members of their securities delivery and payment obligations daily. *See* Rule 204 Adopting Release, 74 FR at 38268 n. 35.

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

## II. Discussion

As discussed with the Division, FINRA and the Exchanges request no-action relief to permit FINRA and the Exchanges to enforce compliance with Rule 204 consistent with, and to permit U.S. registered broker-dealers, including Participants, Allocated Broker-Dealers and Correspondents<sup>20</sup> (collectively “Broker-Dealers”), to use the Multi-day Approach, which would allow Broker-Dealers to claim full or partial Pre-fail Credit for closing out, prior to T+4, a fail to deliver that resulted from a short sale transaction based on net purchases aggregated over multiple days from T+1 through T+3 or, where the fail to deliver resulted from a long sale or is attributable to *bona fide* market making activities, would allow Broker-Dealers to claim full or partial credit for closing out a fail to deliver prior to T+6 based on net purchases aggregated over multiple days from T+1 through T+5 (“Post-fail Credit”) (collectively “Credit”).<sup>21</sup> This request for no-action relief does not address, and the Multi-day Approach would not apply to, the requirements to satisfy a close-out obligation on the applicable close-out date (*i.e.*, T+4 or T+6), except to the extent that the amount of the close-out obligation to be met on the applicable close-out date could be reduced by claiming Credit using the Multi-day Approach based on net purchases prior to the applicable close-out date.<sup>22</sup>

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

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<sup>20</sup> See *infra* note 25.

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

<sup>22</sup> See *infra* paragraph 4.

<sup>23</sup> Rule 204 Adopting Release, 74 FR at 38267.

<sup>24</sup> Rule 204 Adopting Release, 74 FR at 38276.

1. Credit would only be claimed for days on which the Participant or Allocated Broker-Dealer<sup>25</sup> can demonstrate on its books and records that it has net purchases for the day<sup>26</sup> (*i.e.*, is a “net purchaser” or has “net purchases” or “net purchase activity”).<sup>27</sup> The calculation of qualifying net purchases would include the entirety of the *bona fide* trading activity<sup>28</sup> of the Participant or Allocated Broker-Dealer, including proprietary trading as well as trading effected by or on behalf of customers, as reflected on the entirety of the Participant’s or Allocated Broker-Dealer’s books and records (*i.e.*, the trading ledger),<sup>29</sup> provided that the Allocated

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

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

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

<sup>28</sup> The same standard for “*bona fide*” used under Rule 204(e)(1) would continue to apply to the aggregate net purchase activity claimed by a Broker-Dealer for this purpose (*i.e.*, the purchase cannot be a sham close-out). For example, where a Broker-Dealer enters into an arrangement with another person to purchase or borrow securities, and the Broker-Dealer knows or has reason to know that the other person will not deliver securities in settlement of the transaction, the purchase or borrow will not be “*bona fide*.” *See* 17 CFR 242.204(e)(1); Rule 204 Adopting Release, 74 FR at 38275-38276. *See also infra* note 40.

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

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

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

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<sup>30</sup> Where a Broker-Dealer purchases or borrows securities on the applicable close-out date and on that same date engages in sale transactions that can be used to re-establish or otherwise extend the fail, and for which the Broker-Dealer is unable to demonstrate a legitimate economic purpose, the Broker-Dealer will not be deemed to have satisfied the close-out requirement. *See* Rule 204 Adopting Release, 74 FR 38272 n. 82. This could include sale transactions effected by a Broker-Dealer for clearance and settlement through another Participant.

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

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

<sup>33</sup> *See supra* note 30.

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

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

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

<sup>35</sup> Rule 204 does not, by its terms, apply to the allocation of costs by a Broker-Dealer in connection with meeting its close-out requirements. *See* Rule 204 Adopting Release, 74 FR at 38274 n. 102. The Participant or Allocated Broker-Dealer could pass on the economic cost of complying with its Rule 204(a) obligation (*i.e.*, a buy-in) based on agreement or understandings with its Correspondents or customers.

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

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

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

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

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

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

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

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

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

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

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

4. If the aggregate multi-day net purchase amount is less than the full quantity of the fail, it could be used to claim partial Credit, and the Participant or Allocated Broker-Dealer would remain obligated to close out the remaining amount of the fail in accordance with Rule 204(a).
5. Net purchases used to claim Credit, or purchases for compliance with a close-out date (*i.e.*, T+4 or T+6) requirement, with respect to one applicable close-out obligation would not be counted to claim any Credit with respect to a separate and distinct close-out obligation.
6. However, if only a portion of a net purchase is used to claim Credit, or for compliance with a close-out date (*i.e.*, T+4 or T+6) requirement, with respect to one applicable close-out obligation, the remaining portion of the net purchase could be counted to claim Credit with respect to a different close-out obligation.
7. Reliance on the NSCC net delivery obligation under footnote 81 of the Rule 204 Adopting Release would be applied in a manner that avoids double-counting of multi-day activity claimed for Credit. Specifically, to the extent that a reduction in a Participant's fail to deliver at NSCC<sup>43</sup> results from purchases or borrows claimed for Credit or for compliance with a prior close-out date (*i.e.*, T+4 or T+6) requirement, the Participant would not apply such reduction to reduce its close-out obligation because the Participant has already received Credit for such reduction or has applied the reduction to the amount of the Participant's prior close out requirement.<sup>44</sup>
8. In the event of an Allocation to an Allocated Broker-Dealer, the Participant would establish a consistent methodology that would similarly apply footnote 81 of the Rule 204 Adopting Release in a manner that avoids double-counting of multi-day activity claimed for Credit. Specifically, the Participant would apply a methodology to reduce the potential for re-applying a reduction in a Participant's fail to deliver at NSCC<sup>45</sup> that may have resulted from purchases or borrows for compliance with an Allocated Broker-Dealer's close-out requirement and, thus, already have been applied to the amount of the Allocated Broker-Dealer's close out requirement.<sup>46</sup>

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<sup>43</sup> See *supra* note 19.

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

<sup>45</sup> See *supra* note 19.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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<sup>50</sup> See, *e.g.*, FINRA Rule 3130.

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

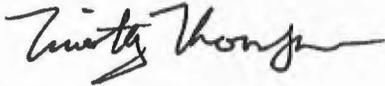
Josephine J. Tao, Esq.  
September 6, 2013  
Page 15 of 19

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

Sincerely,

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

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

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

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

Attachment

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

## Appendix

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

apply to the Participant and its Correspondents until the Participant purchased the full amount of the remaining 400 shares of the fail and that purchase cleared and settled.