



DIVISION OF  
TRADING AND MARKETS

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

April 26, 2017

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

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

Dear Mr. Bergmann:

In your letter dated April 26, 2017 (“Letter”), Murphy & McGonigle, P.C., on behalf of Latour Trading LLC (“Latour” or the “Firm”), a broker-dealer that is an exchange-registered market maker in exchange-traded products, requests assurances that the staff of the Division of Trading and Markets of the Securities and Exchange Commission (the “Commission”) will not recommend to the Commission enforcement action under Rule 204 of Regulation SHO (“Rule 204”) under the Securities Exchange Act of 1934 (the “Exchange Act”),<sup>1</sup> if the Firm, consistent with the approach described in your Letter, closes out a fail to deliver position in the securities of certain exchange-traded products<sup>2</sup> by submitting, no later than the beginning of regular trading hours on the applicable close-out date, irrevocable instructions to create shares in the covered ETF for which the Firm has a Rule 204(a) close-out obligation through an Authorized Participant

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

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

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

Rule 204 requires a participant of a registered clearing agency<sup>5</sup> (“Participant”) to deliver securities to a registered clearing agency for clearance and settlement on a long or short sale transaction in any equity security by settlement date, or to close-out a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security by borrowing or purchasing securities of like kind and quantity.<sup>6</sup> The Participant must close-out a fail to deliver position for a short sale transaction “by no later than the beginning of regular trading hours on the settlement day following the settlement date.”<sup>7</sup> If a Participant has a fail to deliver position that the Participant can demonstrate on its books and records resulted from a long sale, or is attributable to *bona fide* market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the Participant must close-out the fail to deliver position “by no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date.”<sup>8</sup> In the Rule 204 Adopting Release, the Commission specified that to meet its close-out obligation, among other things, a Participant must be able to demonstrate on its books and records that on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position by no later than the beginning of regular trading hours.<sup>9</sup>

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

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

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

<sup>5</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>6</sup> 17 CFR 242.204(a).

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

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

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

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

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

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

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

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<sup>10</sup> 17 CFR 242.204(d).

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

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

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

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

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

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

<sup>15</sup> In some cases, Latour may satisfy its close-out obligation to "borrow[] or purchas[e] securities of like kind and quantity" by acquiring the requisite amount of covered ETF shares through a combination of Creation Orders, irrevocable volume-weighted-average-price ("VWAP") orders for covered ETF shares, and/or a borrow of covered ETF shares. The Commission has permitted the use of VWAP orders to satisfy the requirement to "borrow[] or purchas[e] securities" by "no later than the beginning of regular trading hours" provided: "(i) the order to purchase the equity security on a VWAP basis is irrevocable and received by no later than the beginning of regular trading hours on the applicable close-out date; and (ii) the final execution price of any such transaction is not determined until after the close of regular trading hours when the VWAP value is calculated and the execution is on an agency basis." See Rule 204 Adopting Release, 74 FR at 38271 n.66. In these circumstances, the Firm will note in its books and records the combination of Creation Orders, VWAP orders, and/or borrows that satisfies the specific obligation to "borrow[] or purchas[e] securities of like kind and quantity" under Rule 204(a).

<sup>16</sup> See *supra* note 13.

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

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

6. The Firm will submit the Irrevocable Creation Order to the AP by no later than the beginning of regular trading hours on the applicable close-out date, and will note in its books and records that the Irrevocable Creation Order is in satisfaction, in whole or in part, of the Firm's obligation to "purchas[e] securities of like kind and quantity" under Rule 204(a).
7. The Firm has a reasonable expectation that the AP will confirm that the Irrevocable Creation Order has been filled in its entirety after the close of regular trading hours on the applicable close-out date.
8. If, despite the Firm having submitted an Irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date:
  - (i) the Firm is subsequently on notice before 3:30 p.m. Eastern Time on the close-out date that the Irrevocable Creation Order will not be filled (in whole or part in an amount sufficient to cover the close-out obligation) by the covered ETF, or will not be successfully submitted by the AP to the covered ETF on the close-out date by the deadline established by the covered ETF, the Firm will purchase or borrow<sup>19</sup> covered ETF shares of like kind and quantity in the amount necessary to close-out the Firm's fail to deliver position, as calculated prior to beginning of regular trading hours on the close-out date ("original fail to deliver position") (less any shares in partial fulfillment of the Irrevocable Creation Order), prior to the end of regular trading hours on the close-out date; or
  - (ii) the Irrevocable Creation Order was not filled (in whole or part in an amount sufficient to cover the original fail to deliver position) by the covered ETF after 3:30 p.m. Eastern Time on the close-out date, the Firm will, no later than the beginning of regular trading hours on the following trading day ("next trading day"), purchase or

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

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

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

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

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

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

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

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

#### ETF Creation and Redemption Multi-Day Approach

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

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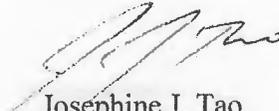
<sup>21</sup> The Firm’s records will include communications with the AP or the covered ETF, if applicable, and any action taken to address a pattern of failure to complete Irrevocable Creation Orders by the AP or the covered ETF.

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

Conclusion

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

Sincerely,



Josephine J. Tao  
Assistant Director

Attachment

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

Dear Ms. Tao:

Murphy & McGonigle, P.C., on behalf of Latour Trading LLC (“Latour” or “Firm”), a broker-dealer that is an exchange-registered market maker in exchange traded products, respectfully requests that the staff of the Division of Trading and Markets (the “Division”) of the Securities and Exchange Commission (“Commission” or “SEC”) provide assurances that it will not recommend to the Commission enforcement action under Rule 204 of Regulation SHO (“Rule 204”) under the Securities Exchange Act of 1934 (the “Exchange Act”),<sup>1</sup> if the Firm closes-out a fail to deliver position in the securities of certain exchange-traded products<sup>2</sup> by

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

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

submitting, no later than the beginning of regular trading hours<sup>3</sup> on the applicable close-out date, irrevocable instructions<sup>4</sup> to create shares in the covered ETF for which the Firm has a Rule 204(a) close-out obligation through an Authorized Participant (“AP”) of the covered ETF (hereinafter, “Creation Order”) in accordance with the approach described below.<sup>5</sup> We also seek confirmation that shares of a covered ETF purchased through the execution of a Creation Order or shares of a covered ETF sold through the execution of a redemption request submitted through an AP of the covered ETF (hereinafter, “Redemption Order”) should be treated in the same manner as purchases or sales of shares of the covered ETF in the secondary market, under the Multi-Day Close-Out Credit Letter (as defined below),<sup>6</sup> when calculating daily net purchases for purposes of Credit (as that term is defined in the Multi-Day Close-Out Credit Letter), as described in more detail below.

#### Regulation SHO Close-Out Requirement under Rule 204

Under Rule 204, a participant of a registered clearing agency<sup>7</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>8</sup> The Participant must close-out a fail to deliver position for a short sale transaction “by no later than the beginning of regular trading hours on the settlement day following the settlement date,” referred to as T+4.<sup>9</sup> If a Participant has a fail to deliver position that the Participant can demonstrate on its books and records resulted from a long sale, or is attributable to *bona fide* market making activities by a registered market maker, options market maker, or other market maker obligated to quote in the over-the-counter market, the Participant must close-out the fail to deliver position “by no later

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

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

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

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

<sup>7</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>8</sup> 17 CFR 242.204(a).

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

than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, referred to as T+6.<sup>10</sup> In the Rule 204 Adopting Release, the Commission specified that to meet its close-out obligation, among other things, a Participant must be able to demonstrate on its books and records that on the applicable close-out date, it purchased or borrowed shares in the full quantity of its fail to deliver position by no later than the beginning of regular trading hours.<sup>11</sup>

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

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

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

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

<sup>11</sup> Rule 204 Adopting Release, 74 FR at 38272.

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

<sup>13</sup> *Id.*

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

pursuant to Rule 204(a) with respect to the shares of the covered ETF, closes-out its fail to deliver position in those shares by submitting<sup>15</sup> an irrevocable Creation Order directly to an AP of the covered ETF no later than the beginning of regular trading hours on the applicable close-out date in accordance with the representations below (the “ETF Creation Approach”):<sup>16</sup>

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

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

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

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

<sup>17</sup> In some cases, Latour may satisfy its close-out obligation to “borrow[] or purchas[e] securities of like kind and quantity” by acquiring the requisite amount of covered ETF shares through a combination of Creation Orders, irrevocable volume-weighted-average-price (“VWAP”) orders for covered ETF shares, and/or a borrow of covered ETF shares. The Commission has permitted the use of VWAP orders to satisfy the requirement to “borrow[] or purchas[e] securities” by “no later than the beginning of regular trading hours” provided: “(i) the order to purchase the equity security on a VWAP basis is irrevocable and received by no later than the beginning of regular trading hours on the applicable close-out date; and (ii) the final execution price of any such transaction is not determined until after the close of regular trading hours when the VWAP value is calculated and the execution is on an agency basis.” See Rule 204 Adopting Release, 74 FR at 38271 n.66. In these circumstances, the Firm will note in its books and records the combination of Creation Orders, VWAP orders, and/or borrows that satisfies the specific obligation to “borrow[] or purchas[e] securities of like kind and quantity” under Rule 204(a).

<sup>18</sup> See *supra* note 15.

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

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

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

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

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

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

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

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

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

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

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

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

Rule 204(e) provides that, even if a Participant has not closed-out a fail to deliver position in accordance with Rule 204(a) or has not allocated a fail to deliver position to a broker-dealer in accordance with Rule 204(d), a broker-dealer may receive credit for purchases or borrows executed prior to the applicable close-out date if the broker-dealer complies with all four requirements set forth in “pre-fail credit” provision in Rule 204(e) (“Pre-Fail Credit”). Specifically, to obtain Pre-Fail Credit under Rule 204(e): (1) the purchase or borrow must be “bona fide”; (2) the purchase or borrow must be executed after the trade date but by no later than the end of regular trading hours on the settlement date for the transaction (accordingly, the purchase or borrow must be executed on T+1, T+2, or T+3); (3) the purchase or borrow must be of a quantity of securities sufficient to cover the entire amount of that broker-dealer’s fail to deliver position at a registered clearing agency in that security; and (4) the broker-dealer can demonstrate that it has a net flat or net long position in the security on its books and records on the day of the purchase or borrow. The Division staff explained that a broker-dealer may only claim Pre-Fail Credit in the limited circumstances where a *bona fide* purchase or borrow for the entire amount of the fail to deliver is effected by that broker-dealer on a single day that is either T+1, T+2 or T+3, and the broker-dealer can demonstrate on its books and records that it has a net flat or net long position on such day.<sup>24</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 NSCC regarding its securities delivery and payment obligations, provided such notification is received prior to the beginning of regular trading hours on the applicable close-out date (i.e., T+4 or T+6).<sup>25</sup>

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

<sup>24</sup> See Multi-Day Close-Out Credit Letter at 2.

<sup>25</sup> See Rule 204 Adopting Release, 74 FR at 38272 n.81.

In the Multi-Day Close-Out Credit Letter, the Division staff allowed a Participant or an Allocated Broker-Dealer to claim Credit for closing-out a fail to deliver position prior to the applicable close-out date<sup>26</sup> based on net purchases over multiple days (the “Multi-Day Approach”).<sup>27</sup>

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

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

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

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

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

### Policy Discussion

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

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

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

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

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

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

<sup>30</sup> See Rule 204 Adopting Release, 74 FR at 38269-38270.

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

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

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

#### Conclusion

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

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

Sincerely yours,



Larry E. Bergmann

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

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<sup>32</sup> See Rule 204 Adopting Release, 74 FR at 38276.

<sup>33</sup> See *id.* at 38287.