



Regulatory Circular RG09-83

Date: August 11, 2009

To: Members
Member Organizations

From: Division of Member and Regulatory Services
Legal Division

Subject: Short Sales,
Temporary Rule 204T of Regulation SHO Now Permanent

OVERVIEW

On July 27, 2009, the Securities and Exchange Commission ("SEC" or "Commission") issued an order making interim final temporary Rule 204T of Regulation SHO permanent effective as of July 31, 2009 (the date on which Rule 204T was set to expire).¹

Rule 204T set out specific requirements to promptly purchase or borrow securities to deliver on long and short sales. The new rule (Rule 204) maintains the structure of Rule 204T with some modifications. These modifications are discussed below and noted by an asterisk (*).

In addition, the SEC's order notes that volume weighted average price (or "VWAP") orders may be utilized to close-out fails to deliver. A VWAP order must be irrevocable, received by no later than the beginning of regular trading hours on the applicable close-out date, have a final execution price that is determined after the close of regular trading hours when the VWAP value is calculated and be executed on an agency basis. (See footnote 66 of the SEC approval order).

DISCUSSION

Requirement to deliver or close-out. Rule 204(a) requires a participant of a registered clearing agency (i.e., a "clearing firm") to deliver securities by settlement date for long or short sales in any equity security, or if the clearing firm has a fail to deliver position in that equity security, the clearing firm shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close-out

¹ See Exchange Act Release 60388 (July 27, 2009). A copy may be found on the CBOE website at the following URL: <http://www.cboe.org/legal/shortsale.aspx>.

the fail to deliver position by borrowing or purchasing securities of like kind and quantity. Rule 204(a) is unchanged from Rule 204T(a).

*Long sales. Rule 204(a)(1), like Rule 204T(a)(1), provides that a clearing firm can close-out a fail to deliver no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, if the clearing firm can demonstrate on its books and records that the fail to deliver resulted from a long sale. Under new Rule 204(a)(1), the fail to deliver can be closed out by either borrowing or purchasing securities of like kind and quantity, whereas borrowing was not permitted under the corresponding provision of Rule 204T.

*Securities deemed to be owned. Rule 204(a)(2) provides that a clearing firm can close-out a fail to deliver position by purchasing no later than the beginning of trading on the 35th consecutive calendar day following trade date in the case of a security that a person is deemed to own pursuant to Rule 200 of Regulation SHO (i.e., is deemed to own the security because he or she owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange) and that such person intends to deliver the security as soon as all restrictions on delivery have been removed. New Rule 204(a)(2) differs in so much as Rule 204T(a)(2) was limited to conversions of Rule 144 securities into unrestricted shares. New Rule 204(a)(2) also differs in so much as Rule 204T(a)(2) allowed a close-out to occur no later than the beginning of regular trading hours on the 36th consecutive settlement day following the settlement date.

*Market-making activity. Rule 204(a)(3) provides that a clearing firm can close-out a fail to deliver no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date, if the fail is attributable to bona fide market-making activities by a registered market-maker, including an options market-maker. Under new Rule 204, the fail to deliver can be closed out by either borrowing or purchasing securities of like kind and quantity, whereas borrowing was not permitted under the corresponding provision of Rule 204T.

Penalty for not closing-out. Rule 204(b) provides that, if a clearing firm does not close-out a fail to deliver position when required, the clearing firm and any broker or dealer for which it clears and settles transactions (including any market maker that would otherwise be entitled to rely on the exception described in the paragraph above) may not accept a short sale order in the equity security from another person or effect a short sale in the equity security for its own account (to the extent that the broker or dealer submits its short sale orders to that clearing firm) without first borrowing the security or entering into a bona fide arrangement to borrow the security, until the clearing firm closes out the fail to deliver position by purchasing securities of like kind and quantity and that purchase has cleared and settled at a registered clearing agency (this is referred to as being in the “pre-borrow” penalty box). This provision of Rule 204(b) has not changed from the corresponding provision of Rule 204T(b).

Exception to pre-borrow penalty box for brokers and dealers. Rule 204(b) also provides that the pre-borrow penalty does not apply to any broker or dealer (including an options market-maker) that timely certifies to the clearing firm that it has not incurred a fail to deliver position on settlement date for a long or short sale in an equity security for which the clearing firm has a fail to deliver position or that the broker or dealer is in compliance with the requirements of Rule 204(e). (see below). Thus, provided that a broker or

dealer can, and does, certify to the clearing firm that the broker or dealer does not have a fail to deliver position or, if applicable, complies with Rule 204(e), it can sell short without a pre-borrow regardless of whether the clearing firm is in a pre-borrow penalty box situation. This provision of Rule 204(b) is unchanged from the corresponding provision contained in Rule 204T(b)(1).

*Exception to penalty box for market makers. Rule 204T(b)(2) had provided an exception from the pre-borrow penalty box that was specific to market makers. Because Rule 204(b) includes an exception applicable to all broker-dealers, including market makers, the SEC did not think it was necessary to maintain a separate exception applicable only to market makers. Thus Rule 204T(b)(2) has been eliminated.

Notification required by clearing firm. Rule 203(c), which is unchanged from Rule 204T(c), requires a clearing firm to notify any broker or dealer for which it clears and settles transactions, including any market-maker that would otherwise be entitled to rely on the exception to the “locate” requirement provided by SEC Rule 203(b)(2)(iii) under Regulation SHO, that 1) the clearing firm has a fail to deliver position in an equity security at a registered clearing agency that has not been closed-out as required and 2) when the purchase executed by the clearing firm to close-out that fail to deliver position has cleared and settled at a registered clearing agency.

A clearing firm can allocate responsibility for a fail to deliver to another broker-dealer. Under Rule 204(d), a clearing firm may reasonably allocate a portion of a fail to deliver position to another registered broker or dealer (including an options market-maker) for which it clears transactions or from which it receives transactions for settlement, based on such broker’s or dealer’s short position. If the clearing firm so allocates, then the clearing firm’s close-out requirement and pre-borrow penalty box requirement described above relating to such fail to deliver position shall apply to such registered broker or dealer allocated the fail to deliver position and not to the clearing firm. This provision of new Rule 204(d) is unchanged from 204T(d).

Notification required of broker or dealer that fails to close-out a fail to deliver allocated to it by a clearing firm. Also under Rule 204(d), a broker or dealer (including an options market-maker) that has been allocated a portion of a fail to deliver and has not complied with the close-out requirement must immediately notify the clearing firm that the broker or dealer has become subject to the pre-borrow penalty box. This provision of new Rule 204(d) is unchanged from Rule 204T(d).

*Close-outs executed by broker-dealers for pre-fail credit. Rule 204(e) provides that, even if the clearing firm has not closed-out a fail to deliver in accordance with 204(a) or has not allocated a fail to deliver to a broker-dealer in accordance with Rule 204(d), a broker-dealer that borrows or purchases securities to close out a fail to deliver after the trade date, but no later than the end of regular trading hours on settlement date for the transaction, shall not be subject to the close-out and pre-borrow penalty box requirements of 204(a) and 204(b), respectively. In addition to the timing requirement above, the borrow or purchase must be bona fide, the borrow or purchase must be for a quantity of securities sufficient to cover the entire amount of the broker-dealer’s fail to deliver position at a registered clearing agency in that security, and the broker-dealer must be able to demonstrate that it had a net flat or net long position on its books and records on the day of the borrow or purchase. In contrast, Rule 204T(e) did not permit borrowing, allowed the purchase to occur at anytime prior to the beginning of regular

trading hours on the settlement day after the settlement date, and required the entire short position to be closed-out rather than just the fail to deliver position.²

*Legitimacy of borrow or purchase to close-out. Pursuant to Rule 204(f), a clearing firm shall not be deemed to have fulfilled the requirements of Rule 204 if it enters into an arrangement with another person to borrow or purchase securities as required by Rule 204, and the clearing firm knows or has reason to know that the other person will not deliver securities in settlement of the borrow or purchase. In contrast to Rule 204T, this is a new provision.

Definitions. Rule 204T(f) contained definitions of “settlement date” and “regular trading hours.” These definitions are unchanged, but have been moved to a new paragraph (g) of Rule 204.

The goal of this Regulatory Circular is to make you aware of the changes to Regulation SHO. We encourage you to review the complete SEC order, which may be found on the SEC’s website at <http://www.sec.gov/rules/final/2009/34-60388.pdf> or the CBOE’s website at <http://www.cboe.org/legal/shortsale.aspx>. An SEC press release discussing this order and other SEC short sale initiatives may also be found on the SEC’s website at <http://www.sec.gov/news/press/2009/2009-172.htm>. Any questions on this circular may be directed to any of the following individuals:

Jennifer Lame at lamie@cboe.com or 312-786-7576
James Adams at adams@cboe.com or 312-786-7718
Robert Gardner at gardner@cboe.com or 312-786-7937

² Rule 204T(e) had conflicting language concerning the timing of the close-out. Paragraph (e) had indicated that the purchase could be executed prior to the beginning of regular trading hours on the settlement day after the settlement date. Subparagraph (e)(2) had indicated that the purchase could be executed no later than the end of regular trading hours on settlement date.