



Regulatory Circular RG12-022

To: Trading Permit Holders and  
Clearing Trading Permit Holders

From: Division of Regulatory Services

Date: January 30, 2012

Subject: Close-Out Requirements Under Rule 204 of Regulation SHO

This circular is being issued to remind market participants of certain aspects of Regulation SHO in response to questions received by the Exchange.

The Division of Regulatory Services reminds all participants of registered clearing agencies (i.e., clearing firms) of their obligation under Rule 204 of Regulation SHO to immediately close-out fail to deliver positions by borrowing or purchasing securities of like kind and **quantity** by no later than the applicable deadline.<sup>1</sup>

The quantity of securities borrowed or purchased by the beginning of regular trading hours on the applicable close-out date must be for the same quantity (or more) and of the same security as the fail to deliver position at the registered clearing agency. A participant may not offset the amount of its fail to deliver position with shares that the participant receives or will receive during the applicable close-out date.<sup>2</sup> Further, the amount of securities that must be borrowed or purchased to close out the fail to deliver position may not be reduced by an incremental borrow or net purchase, effected on the first, second and/or third settlement days following the trade date.

However, a participant may qualify for pre-fail credit in lieu of becoming subject to the close-out requirement by purchasing or borrowing on any single day after trade date, but by no later than the end of regular trading hours on settlement date for the transaction, 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 accordance with all of the requirements set forth under Rule 204(e), the pre-fail credit provision. Specifically, Rule 204(e) provides that a broker or dealer shall not be subject to the requirements of paragraph (a) or (b) of Rule 204 if the broker or dealer purchases or borrows the securities, and if: (1) the purchase or borrow is bona-fide; (2) the purchase or borrow is executed after trade date but by no later than the end of regular trading hours on settlement date for the transaction; (3) the purchase or borrow is of a quantity of securities sufficient to cover the entire amount of that broker's or dealer's fail to deliver position at a registered clearing agency in that security; and (4) the broker or dealer can demonstrate that it has a net flat or net long position on its books and records on the day of the purchase or borrow.

This reminder also applies to other broker-dealers in that, if a clearing firm reasonably allocates, pursuant to Rule 204(d), a portion of a fail to deliver position at a registered clearing agency to another registered broker-dealer for which it clears trades or from which it receives trades for settlement, based on such broker-dealer's short position, the requirement to close-out such fail

to deliver position at a registered clearing agency is the responsibility of such broker-dealer that was allocated the fail to deliver position and not the clearing firm.

Further, the information provided in this circular is, in all cases, subject to the “anti-sham” provisions of Rule 204(f) and Rule 203(b)(3)(vii) of Regulation SHO, pursuant to which a clearing firm, or a broker-dealer to whom a fail to deliver position has been allocated, is not deemed to have fulfilled its close out obligation under Regulation SHO where the clearing firm or broker-dealer enters into an arrangement with another person to purchase or borrow securities and the clearing firm or broker-dealer knows, or has reason to know, that the other person will not deliver securities in settlement of the purchase or borrow. This circular is not intended to, and does not provide any relief from or exception to the “anti-sham” provisions of Regulation SHO. Moreover, where a clearing firm, or a broker-dealer to whom a fail to deliver position has been allocated, purchases or borrows securities on the applicable close-out date and pairs that activity with entering into one or more short-term option positions that can be used to re-establish or otherwise extend the participant’s fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement. For further information, see footnote 82 in the Securities and Exchange Commission’s adopting release for Rule 204.<sup>3</sup> Also, see CBOE Regulatory Circulars RG07-87 and RG08-63.

## DISCUSSION

Questions concerning the quantity of securities that must be borrowed or purchased to fulfill the close-out requirements of Rule 204 of Regulation SHO and concerning the requirements for pre-fail credit under the Rule are given below along with answers.

1. If a clearing firm incurs a fail to deliver position in a security at a registered clearing agency, or a broker-dealer is allocated a fail to deliver position at a registered clearing agency by its clearing firm, in an amount greater than the clearing firm’s, or broker-dealer’s, net open short position in that security, may the clearing firm, or broker-dealer, purchase or borrow shares in the amount of its net open short position to satisfy the close-out requirement of Rule 204 of Regulation SHO?

No. The close-out requirement of Rule 204 of Regulation SHO requires a clearing firm with a fail to deliver position in a security at a registered clearing agency, or a broker-dealer allocated such a fail to deliver position to borrow or purchase the entire amount of its fail to deliver position in the security at the relevant registered clearing agency or the allocated portion thereof by the applicable deadline. The amount of the broker-dealer’s net open short position is not relevant for purposes of determining the broker-dealer’s close-out obligation.

2. If a clearing firm incurs a fail to deliver position in a security at a registered clearing agency, or a broker-dealer is allocated a fail to deliver position at a registered clearing agency by its clearing firm, but has borrowed or purchased the security in increments over the course of T+1, T+2 and T+3 in an aggregate amount equal to or greater than the amount of its fail to deliver position, has the clearing firm or broker-dealer satisfied the close out requirement under Rule 204 of Regulation SHO?

No. Rule 204 of Regulation SHO requires the clearing firm with a fail to deliver position, or a broker-dealer allocated a fail to deliver position, to borrow or purchase the entire amount of the fail to deliver position or the allocated portion by the applicable deadline. A clearing firm or broker-dealer may only receive credit for a borrow or purchase made after trade date but prior to incurring, or being allocated, a fail to deliver position where the borrow or purchase meets all of the requirements of Rule 204(e). In particular, the borrow or purchase must be for the entire amount of the fail to deliver position and the

entire amount must be purchased or borrowed on one of T+1, T+2 or T+3. For example, if a clearing firm with a close out obligation for a fail to deliver position of 100,000 shares purchased 25,000 shares on T+1 and 75,000 shares on T+2, the clearing firm would not qualify for pre-fail credit under Rule 204(e), even if the clearing firm otherwise met all the requirements for pre-fail credit under Rule 204(e), because the clearing firm did not purchase the entire amount of the fail to deliver position on a single day.

3. If (i) a clearing firm incurs a fail to deliver position in a security at a registered clearing agency, or (ii) a broker-dealer is allocated a fail to deliver position at a registered clearing agency by its clearing firm, but in either instance the clearing firm or broker-dealer has borrowed or purchased the security in an amount equal to or greater than the entire amount of its fail to deliver position on one of T+1, T+2 or T+3, has the clearing firm or broker-dealer satisfied the close out requirement under Rule 204 of Regulation SHO, provided that the borrow or purchase was the result of affirmative action to close out an anticipated fail to deliver position and was not otherwise the result of offsetting the amount of its anticipated fail to deliver position with purchases or borrows that the clearing firm or broker-dealer effected in the normal course of business? Why or why not?

Yes, provided that all other requirements under Rule 204(e) are also met, and the borrow or purchase of the security must be bona fide. 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."<sup>4</sup> Similarly, where a clearing firm, or a broker-dealer to whom a fail to deliver position has been allocated, purchases or borrows securities on the applicable close-out date and pairs that activity with entering into one or more short-term option positions that can be used to re-establish or otherwise extend the participant's fail position, and for which the participant is unable to demonstrate a legitimate economic purpose, the participant will not be deemed to have satisfied the close-out requirement. The broker-dealer also must be able to demonstrate that it has a net flat or net long position on its books and records on the day of borrow or purchase.

Questions regarding this Regulatory Circular should be directed to the Exchange's Regulatory Interpretations and Guidance unit at (312) 786-8141 or [reginterps@cboe.com](mailto:reginterps@cboe.com).

---

<sup>1</sup> In the case of fail to deliver positions for which the participant can demonstrate on its books and records that such fail to deliver position resulted from a long sale, and fail to deliver positions that are 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 applicable deadline is no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date.

In the case of fail to deliver positions resulting from a sale of a security that a person is deemed to own pursuant to Rule 200 of Regulation SHO and that such person intends to deliver as soon as all restrictions on delivery have been removed, the applicable deadline is no later than the beginning of regular trading hours on the thirty-fifth consecutive calendar day following the trade date for the transaction.

In the case of all other fail to deliver positions, the applicable deadline is no later than the beginning of regular trading hours on the settlement day following the settlement date.

<sup>2</sup> Under Rule 204's close-out requirements, a participant must take affirmative action to close out a fail to deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours on the relevant close-out date.

<sup>3</sup> Securities Exchange Act Release No. 60388 (July 27, 2009), 74 FR 38266 (July 31, 2009).

<sup>4</sup> See *also* Rule 204(f) and Rule 203(b)(3)(vii) of Regulation SHO.