

## **DRAFT**

### SUPPORTING STATEMENT TEMPORARY RULE 204T

This submission pursuant to the Paperwork Reduction Act of 1995, 44 U.S.C. Section 3501 et seq., consists of this supporting statement and the following exhibits:

- A. Statutory Authority
- B. Written Statement Supporting Need for Emergency Consideration

#### A. Justification

##### 1. Necessity of Information Collection

###### i. Allocation Notification Requirement

Temporary Rule 204T(d) imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the temporary rule's requirements that is designed to help ensure that participants that receive trades for clearance and settlement from broker-dealers will be on notice that the broker-dealer is subject to the borrow requirements of temporary Rule 204T(b) until the fail to deliver position has been closed out.

###### ii. Demonstration Requirement for Fails to Deliver on Long Sales

Temporary Rule 204T(a)(1) allows a participant an additional two settlement days in which to close out the fail to deliver position that resulted from a long sale, provided that the participant's books and records reflect the fact that the fail to deliver resulted from a long sale.

###### iii. Pre-Borrow Notification Requirement

Temporary Rule 204T(c)'s notification requirement is designed to help ensure that all broker-dealers that submit trades for clearance and settlement to a participant that has a fail to deliver position in an equity security that has not been closed out in accordance with temporary Rule 204T(a) will be on notice that short sales in that security will be subject to the borrow requirements of temporary Rule 204T(b) until the fail to deliver position has been closed out.

###### iv. Certification Requirement

The temporary rule includes an exception from the borrowing requirements for any broker-dealer that can demonstrate that it was not responsible for any part of the fail to deliver position of the participant. The information collected will help ensure that broker-dealers are complying with the requirements of the temporary rule.

v. Pre-Fail Credit Demonstration Requirement

Temporary Rule 204T(e)'s Pre-Fail Credit provision requires, among other things, that the broker-dealer demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker-dealer is claiming credit. The information collected will help ensure that broker-dealers purchase sufficient shares to close out their fail to deliver position prior to the beginning of regular trading hours on the close-out date.

vi. Market Maker Demonstration Requirement

The borrowing requirements of temporary rule do not apply to a Market Maker that can demonstrate that it does not have an open fail to deliver position at the time of any additional short sales. This demonstration requirement is designed to help ensure that Market Makers are complying with the requirements of temporary Rule 204T(b)(2).

2. Purpose of, and Consequences of Not Requiring, the Information Collection

The information collected will further the Commission's goals of reducing fails to deliver, which may have a negative effect on the securities market and also may be used to facilitate some manipulative trading strategies. By strengthening the delivery requirements and promoting the prompt and accurate clearance and settlement of transactions involving equity securities, the temporary rule is intended to substantially restrict the practice of "naked" short selling. In addition, the information collected will aid the Commission and self-regulatory organizations in monitoring compliance with the temporary rule's requirements.

3. Role of Improved Information Technology and Obstacles to Reducing Burden

The compilation of this information must be done on an individual basis by each respondent subject to any of the requirements discussed in item 1, above. Thus, improved information technology would not reduce the burden.

4. Efforts to Identify Duplication

We are not aware of duplication of this information.

5. Effects on Small Entities

The collection of information necessary to ensure compliance with the temporary rule's requirements is not unduly burdensome on smaller entities.

6. Consequences of Less Frequent Collection

In order to ensure compliance with the temporary rule, a participant or broker-dealer subject to any of the requirements discussed in item 1, above, must collect the required information on a

daily basis. Less frequent or less individualized collection would impede the ability to verify compliance with the temporary rule.

7. Inconsistencies with Guidelines in 5 CFR § 1320.5(d)(2)

The information collection is not conducted in a matter that is inconsistent with 5 CFR § 1320.5(d)(2).

8. Consultations Outside the Agency

The Commission has been coordinating extensively with other financial regulators to address the current threats to fair and orderly securities markets. Due to the exigent circumstances, the Commission is unable to solicit prior public comment on the collection and estimated burden.

9. Payment or Gift to Respondents

Not applicable.

10. Assurances of Confidentiality

No assurances of confidentiality are provided in the statute or the Rule.

11. Sensitive Questions

Not applicable; no information of a sensitive nature is required under the temporary rule.

12. Estimate of Respondent Reporting Burden

i. Allocation Notification Requirement

We estimate that it will take a broker-dealer no more than approximately 0.16 hours (10 minutes) to notify a participant that the broker-dealer has become subject to the requirements of temporary Rule 204T(b). We base this estimate in part on the fact that, in accordance with Rule 203(b)(3)(vi) of Regulation SHO, participants are permitted to allocate responsibility to close out a portion of a fail to deliver position to a broker-dealer that is responsible for the fail to deliver position; the fact that most broker-dealers already have the necessary communication mechanisms in place and are already familiar with notification processes and procedures to comply with the borrowing requirements of Rule 203(b)(3)(iv) of Regulation SHO for threshold securities; and the fact that broker-dealers will be able to continue to use the same communication mechanisms, processes and procedures to comply with the notification requirement of temporary Rule 204T(b). On average, we estimate that currently it takes

approximately 0.16 hours (10 minutes) to notify broker-dealers pursuant to Rule 203(b)(3)(iv) of Regulation SHO.<sup>1</sup>

If a broker-dealer has been allocated a portion of a fail to deliver position in an equity security and after the beginning of regular trading hours on the close-out date (or, in the case of a fail to deliver that has resulted from a long sale, on the third consecutive settlement day following the settlement date), the broker-dealer has to determine whether or not that portion of the fail to deliver position was not closed out in accordance with temporary Rule 204T(a), we estimate that a broker-dealer will have to make such determination with respect to approximately 1.76 equity securities per day.<sup>2</sup>

As of December 31, 2007, there were 5,561 registered broker-dealers. Each of these broker-dealers could clear trades through a participant of a registered clearing agency and, therefore, become subject to the notification requirements of temporary Rule 204T(b). We estimate a total of 2,466,415 notifications in accordance with temporary Rule 204T(b) across all broker-dealers (that were allocated responsibility to close out a fail to deliver position) per year (5,561 broker-dealers notifying participants once per day<sup>3</sup> on 1.76 securities, multiplied by 252 trading days in a year). The total estimated annual burden hours per year will be approximately 394,626 burden hours (2,466,415 multiplied by 0.16 hours/notification). We estimate that the paperwork burden for the allocation notification requirement for each broker-dealer will be approximately 71.0 burden hours per year.

#### ii. Demonstration Requirement for Fails to Deliver on Long Sales

We estimate that it will take a participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to demonstrate in its books and records that it has a fail to deliver position at a registered clearing agency in an equity security that resulted from a long sale. We base this estimate on the fact that, to comply with Regulation SHO's marking requirements, broker-dealers are already required to ascertain whether a customer is "deemed to own" the securities being sold before marking a sell order "long" and, if the securities are not in the broker-dealer's physical possession or control, whether the broker-dealer reasonably expects

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<sup>1</sup> We base this estimate on information provided to our staff by three large, three medium, and three small registered clearing agency participants.

<sup>2</sup> Our Office of Economic Analysis ("OEA") estimates that there are approximately 9,809 fail to deliver positions per settlement day. Across 5,561 broker-dealers, the number of securities per broker-dealer per day is approximately 1.76 equity securities. During the period from January to July 2008, approximately 4,321 new fail to deliver positions occurred per day. The NSCC data for this period includes only securities with at least 10,000 shares in fails to deliver. To account for securities with fails to deliver below 10,000 shares, the figure is grossed-up by a factor of 2.27. The factor is estimated from a more complete data set obtained from NSCC during the period from September 16, 2008 to September 22, 2008. It should be noted that these numbers include securities that were not subject to the close-out requirement of Rule 203(b)(3) of Regulation SHO.

<sup>3</sup> Because failure to comply with the close-out requirements of temporary Rule 204T(a) is a violation of the temporary rule, we believe that a broker-dealer would make the notification to a participant that it is subject to the borrowing requirements of temporary Rule 204T(b) at most once per day.

that the shares will be in the broker-dealer's physical possession or control by settlement date. This reasonableness determination includes consideration of whether or not a prior sale resulted in a fail to deliver position. In addition, broker-dealers already must comply with the documentation requirement contained in the "locate" requirement of Rule 203(b)(1) of Regulation SHO. Participants will be able to use similar mechanisms, processes and procedures to demonstrate compliance with the temporary rule's close-out requirement for fails to deliver resulting from long sales as they use for compliance with the current requirements of Regulation SHO.

If a participant of a registered clearing agency has a fail to deliver position in an equity security at a registered clearing agency and determined that such fail to deliver position resulted from a long sale, we estimate that a participant of a registered clearing agency will have to make such determination with respect to approximately 34 securities per day.<sup>4</sup>

As of July 31, 2008, there were 197 participants of NSCC, the primary registered clearing agency responsible for clearing U.S. transactions that were registered as broker-dealers. We estimate a total of 1,687,896 demonstrations in accordance with temporary Rule 204T(a)(1) across all participants per year (197 participants checking for compliance once per day on 34 securities, multiplied by 252 trading days in a year). The total approximate estimated annual burden hour per year will be approximately 270,063 burden hours (1,687,896 multiplied by 0.16 hours/documentation). We estimate that the paperwork burden for the temporary demonstration provision for each participant will be approximately 1,371 burden hours per year.

### iii. Pre-Borrow Notification Requirement

We estimate that it will take a participant of a registered clearing agency no more than approximately 0.16 hours (10 minutes) to notify all broker-dealers from which the participant receive orders for clearance and settlement (1) that the participant has a fail to deliver position in an equity security at a registered clearing agency that has not been closed out in accordance with the requirements of temporary Rule 204T(a), and (2) when the purchase that the participant has made to close out the fail to deliver position has cleared and settled at a registered clearing agency.<sup>5</sup> We base this estimate in part on the fact that most participants already notify broker-dealers for which they receive orders for clearance and settlement that the participant has a fail to deliver position in a threshold security that has not been closed out in order to comply with the borrow requirements of Rule 203(b)(3)(iv) of Regulation SHO for threshold securities; the fact that most participants already have the necessary communication mechanisms in place and are already familiar with notification processes and procedures to comply with the borrow

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<sup>4</sup> OEA estimates approximately 68% of trades are long sales and applies this percentage to the number of fail to deliver positions per day. 68% of 50 securities per day is 34 securities per day. The 68% figure is estimated as 100% minus the proportion of short sale trades found in the Regulation SHO Pilot Study (*see* <http://www.sec.gov/news/studies/2007/regshopilot020607.pdf> ).

<sup>5</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

requirements of Rule 203(b)(3)(iv) of Regulation SHO for threshold securities; and the fact that participants will be able to continue to use the same communication mechanisms, processes and procedures to notify any broker-dealers from which it receives trades for clearance and settlement of the information required by the temporary rule's notification requirement as they use for compliance with Regulation SHO.

If a participant of a registered clearing agency has a fail to deliver position in an equity security and after the beginning of regular trading hours on the close-out date (or, in the case of a fail to deliver that resulted from a long sale, on the third consecutive settlement day following the settlement date), the participant has to determine whether or not the fail to deliver position was closed out in accordance with temporary Rule 204T(a), we estimate that a participant of a registered clearing agency will have to make such determination with respect to approximately 50 equity securities per day.<sup>6</sup>

As of July 31, 2008, there were 197 participants of NSCC, the primary registered clearing agency responsible for clearing U.S. transactions that were registered as broker-dealers.<sup>7</sup> We estimate a total of 2,482,200 notifications in accordance with temporary Rule 204T(c) across all participants per year (197 participants notifying broker-dealers once per day on 50 securities, multiplied by 252 trading days in a year). The total estimated annual burden hours per year will be approximately 397,152 burden hours (2,482,200 multiplied by 0.16 hours/documentation). We estimate that the paperwork burden for the notification requirement for each participant will be approximately 2,016 burden hours per year.

#### iv. Certification Requirement

We estimate that it will take such broker-dealer no more than approximately 0.16 hours (10 minutes) to certify to the participant that that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or that it is in compliance with the requirements set forth in the Pre-Fail Credit provision of the temporary Rule 204T(e). We base this estimate, in part, on the fact that, to comply with the close-out requirements of Rule 203(b) of Regulation SHO, current industry practice for some participants that are registered broker-dealers is to document purchases made on settlement days 11, 12, and 13 to demonstrate that such participants do not

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<sup>6</sup> See *supra* note 2.

<sup>7</sup> Those participants not registered as broker-dealers include such entities as banks, U.S.-registered exchanges, and clearing agencies. Although these entities are participants of a registered clearing agency, generally these entities do not engage in the types of activities that will implicate the close-out requirements of the temporary rule. Such activities of these entities include creating and redeeming Exchange Traded Funds, trading in municipal securities, and using NSCC's Envelope Settlement Service or Inter-city Envelope Settlement Service. These activities rarely lead to fails to deliver and, if fails to deliver do occur, they are small in number and are usually closed out within a day. Thus, such fails to deliver will not trigger the close-out requirement of the temporary rule.

have a close-out obligation under Regulation SHO. On average, participants informed us that such documentation takes approximately 0.16 hours (10 minutes).<sup>8</sup>

If the broker-dealer determines that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or has purchased securities in accordance with the conditions specified in temporary Rule 204T(e), we estimate that a broker-dealer will have to make such determinations with respect to approximately 1.76 securities per day. As of December 31, 2007, there were 5,561 registered broker-dealers. Each of these broker-dealers may clear trades through a participant of a registered clearing agency. We estimate that on average, a broker-dealer will have to certify to the participant that that it has not incurred a fail to deliver position on settlement date in an equity security for which the participant has a fail to deliver position at a registered clearing agency or, alternatively, that it is in compliance with the requirements set forth in the Pre-Fail Credit provision of the temporary Rule 204T(e), 2,466,415 times per year (5,561 broker-dealers certifying once per day on 1.76 securities, multiplied by 252 trading days in a year). Thus, the total approximate estimated annual burden hour per year will be approximately 394,626 burden hours (2,466,415 multiplied by 0.16 hours/certification). We estimate that the paperwork burden for the certification provision for each broker-dealer will be approximately 71.0 burden hours per year.

v. Pre-Fail Credit Demonstration Requirement

We estimate that it will take a broker-dealer no more than approximately 0.16 hours (10 minutes) to demonstrate that it has a net long position or net flat position on its books and records on the settlement day for which the broker or dealer is claiming credit. We base this estimate on the fact that, to comply with the close-out requirement of Rule 203(b)(3) of Regulation SHO, current industry practice for some participants that are registered broker-dealers is to document purchases made on settlement days 11, 12, and 13 to demonstrate that such participants do not have a close-out obligation under Regulation SHO. On average, participants informed us that such documentation takes approximately 0.16 hours (10 minutes).

If a broker-dealer purchased securities in accordance with the conditions specified in temporary Rule 204T(e) and determined that it has a net long position or net flat position on the settlement day for which the broker-dealer is claiming credit, we estimate that a broker-dealer will have to make such determination with respect to approximately 34 securities per day.

As of December 31, 2007, there were 5,561 registered broker-dealers. We estimate that on average, a broker-dealer will have to demonstrate in its books and records that it has a net long position or net flat position on the settlement day for which the broker-dealer is claiming credit, 1,681,646 times per year (5,561 broker-dealers checking for compliance once per day on 1.20 securities, multiplied by 252 trading days in a year). Thus, the total approximate estimated

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<sup>8</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

annual burden hour per year will be approximately 269,063 burden hours (1,681,646 multiplied by 0.16 hours/demonstration). We estimate that the paperwork burden for the temporary Pre-Fail Credit provision for each broker-dealer will be approximately 48.4 burden hours per year.

vi. Market Maker Attestation Requirements

We estimate that it will take a Market Maker no more than approximately 0.16 hours (10 minutes) to demonstrate that it does not have an open fail to deliver position at the time of any additional short sales. We base this estimate on information obtained from market makers currently complying with temporary Rule 204T, pursuant to the September Emergency Order.<sup>9</sup>

If a participant of a registered clearing agency has a fail to deliver position in an equity security at a registered clearing agency that is attributable to a Market Maker and the Market Maker, in seeking to avoid the borrowing requirements of temporary Rule 204T(b), has determined that it does not have an open fail to deliver position, we estimate that such Market Maker will have to make such determination with respect to approximately 15 securities per day.<sup>10</sup>

As of December 31, 2007, there were 656 Market Makers.<sup>11</sup> We estimate a total of 2,479,680 demonstrations in accordance with temporary Rule 204T(b)(1) across all Market Makers per year (656 Market Makers demonstrating once per day on 15 securities, multiplied by 252 trading days in a year). Thus, the total approximate estimated annual burden hour per year will be approximately 396,749 burden hours (2,479,680 multiplied by 0.16 hours/demonstration). We estimate that the paperwork burden for the Market Maker demonstration requirements for each Market Maker will be approximately 604.8 burden hours per year.

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<sup>9</sup> We base this estimate on information provided to our staff by three large, three medium, and three small firms that engage in market making activities currently complying with temporary Rule 204T, pursuant to the September Emergency Order, which has similar requirements to temporary Rule 204(T)(b)(2).

<sup>10</sup> OEA estimates that there are approximately 9,809 fail to deliver positions per day. An upper bound on the number of fail to deliver positions per day due to market makers is 9,809. Across 656 market makers, the number of securities per market maker per day is approximately 15 equity securities. During the period from January to July 2008, approximately 4,321 new fail to deliver positions occurred per day. The NSCC data for this period includes only securities with at least 10,000 shares in fails to deliver. To account for securities with fails to deliver below 10,000 shares, the figure is grossed-up by a factor of 2.27. The factor is estimated from a more complete data set obtained from NSCC during the period from September 16, 2008 to September 22, 2008. It should be noted that these numbers include securities that were not subject to the close-out requirement of Rule 203(b)(3) of Regulation SHO.

<sup>11</sup> These numbers are based on OEA's review of 2007 FOCUS Report filings reflecting registered broker-dealers. This number does not include broker-dealers that are delinquent on FOCUS Report filings.



13. Estimate of Total Annualized Cost Burden

Not applicable.

14. Estimate of Cost to the Federal Government

Not applicable.

15. Explanation of Changes in Burden

Not applicable.

16. Information Collections Planned for Statistical Purposes

Not applicable; there is no intention to publish the information for statistical purposes.

17. Explanation as to why Expiration Date will not be Displayed

Not applicable.

18. Exceptions to Certification

Not applicable.

B. Collection of Information Employing Statistical Methods

The collection of information does not employ statistical methods, nor would the implementation of such methods reduce burden or improve accuracy of results.