

SUPPORTING STATEMENT  
RULE 204

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:

I. Statutory Authority

A. Justification

1. Necessity of Information Collection

i. Allocation Notification Requirement

Rule 204(d) of Regulation SHO imposes a notification requirement on a broker-dealer that has been allocated responsibility for complying with the rule's requirements that is designed to help ensure that participants will be on notice if a broker-dealer for which they clear and settle trades has become subject to the rule's borrowing requirements.

ii. Demonstration Requirement for Fails to Deliver on Long Sales

Rule 204(a)(1) of Regulation SHO 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 can demonstrate on its books and records that the fail to deliver position resulted from a long sale.

iii. Pre-Borrow Notification Requirement

Rule 204(c) of Regulation SHO requires that a participant notify all broker-dealers from which it receives trades for clearance and settlement if it has a fail to deliver position that has not been closed out in accordance with Rule 204. This 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 a security that has not been closed out in accordance with Rule 204 will be on notice that short sales in that security to be cleared or settled through that participant will be subject to the borrow requirements of Rule 204(b) until the fail to deliver position has been closed out, or unless the broker-dealer can demonstrate, as specified in Rule 204(b), that it is not responsible for the fail to deliver position.

iv. Certification Requirement

Rule 204(b) of Regulation SHO includes an exception from the rule's 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 a broker-dealer will not be subject to the borrowing requirements of the rule if the broker-dealer

can demonstrate that it did not incur a fail to deliver position in the security on settlement date, or if it has taken steps, in accordance with Rule 204(e), to close out the fail to deliver position.

v. Pre-Fail Credit Demonstration Requirement

Rule 204(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 enable the Commission and self-regulatory organizations ("SROs") to monitor more effectively whether or not a broker-dealer has complied with the requirements of Rule 204(e).

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

The information collected will help further the Commission's goal of reducing fails to deliver by maintaining the reductions in fails to deliver achieved by, among other actions, the adoption of Interim Final Temporary Rule 204T ("temporary Rule 204T"), which had been implemented via emergency order on September 17, 2008 and adopted as an interim final temporary rule on October 14, 2008.<sup>1</sup> Rule 204 makes permanent amendments contained in temporary Rule 204T, with some limited modifications to address commenters' concerns.

The information collected under Rule 204 will continue to be retained and/or provided to other entities pursuant to the specific rule provisions and will be available to the Commission and SRO examiners upon request. The information collected will continue to aid the Commission and SROs in monitoring compliance with these requirements. In addition, the information collected will aid those subject to Rule 204 in complying with its requirements.

In addition, Rule 204 is intended to help further the Commission's goal of addressing potentially abusive "naked" short selling in all equity securities. By strengthening the close-out requirements of Regulation SHO and promoting the prompt and accurate clearance and settlement of transactions involving equity securities, Rule 204 is intended to help restrict the practice of "naked" short selling.

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.

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<sup>1</sup> Exchange Act Release No. 58733 (Oct. 14, 2008), 73 FR 61706 (Oct. 17, 2008) ("Rule 204T Adopting Release").

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 Rule 204's requirements is not unduly burdensome on smaller entities.

6. Consequences of Less Frequent Collection

In order to ensure compliance with Rule 204, 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 Rule 204.

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

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

8. Consultations Outside the Agency

We published a notice of our estimated time requirements for participants to comply with these collection of information provisions and requested comment on the collection of information requirements in connection with temporary Rule 204T.<sup>2</sup> We submitted the collection of information to the Office of Management and Budget ("OMB") for review and approval in accordance with 44 U.S.C. 3507(j) and 5 CFR 1320.13. With the single exception of the elimination in Rule 204 of the exception in temporary Rule 204T(b)(2) for market makers from the borrowing requirement in Rule 204(b),<sup>3</sup> all collections of information from temporary Rule 204T have been incorporated into Rule 204 without modification. The collection of information requirements of temporary Rule 204T have not been substantively or materially modified in Rule 204; therefore, the time and cost estimates for compliance with these

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<sup>2</sup> Rule 204T Adopting Release, 17 FR 61706, 61722.

<sup>3</sup> In contrast to temporary Rule 204T(b), Rule 204(b) does not include an exception from the borrowing requirement of the Rule specific to market makers. We eliminated this exception because, as with other broker-dealers, a market maker is excepted from the borrowing requirements of Rule 204(b) if it timely certifies to the participant 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 participant has a fail to deliver position at the registered clearing agency or that it is in compliance with the requirements of Rule 204(e). Market makers, like all other broker-dealers, will continue to be subject to the certification requirements under Rule 204(b).

provisions are the same for Rule 204 as our prior time and cost estimates for temporary Rule 204T,<sup>4</sup> which we incorporated into the Rule 204 adopting release by reference.<sup>5</sup>

One commenter to the Rule 204T Adopting Release indicated that compliance with temporary Rule 204T resulted in an increase in man-hours to monitor multiple levels of data across various system platforms and business units within a firm,<sup>6</sup> and other commenters expressed general concerns with the administrative and operational burdens on clearing firms, customers, and their regulators.<sup>7</sup> The Commission, however, did not receive any comments as to the burdens associated with the collection of information requirements in temporary Rule 204T.

9. Payment or Gift to Respondents

Not applicable.

10. Assurances of Confidentiality

No assurances of confidentiality is provided.

11. Sensitive Questions

Not applicable; no information of a sensitive nature is required under Rule 204.

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 Rule 204(b) of Regulation SHO. 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; 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

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<sup>4</sup> See Rule 204T Adopting Release, 17 FR 61706, 61717-61722.

<sup>5</sup> See *infra* note 24.

<sup>6</sup> See letter from Amal Aly, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association, dated Dec. 16, 2008. The commenter noted that one firm indicated its operations personnel initially spent an extra 60 man-hours per day to comply with the rule, but acknowledged that time amount had tapered down through automation.

<sup>7</sup> See *e.g.*, letters from Edward J. Joyce, President and Chief Operating Officer, Chicago Board Options Exchange, dated Dec. 23, 2008 and Stefan Gavell, Executive Vice President and Head of Regulatory Industry Affairs, State Street Corporation, dated Dec. 16, 2008.

securities; and that broker-dealers will be able to continue to use the same communication mechanisms, processes and procedures to comply with the notification requirement of Rule 204(d).<sup>8</sup> On average, participants estimate that currently it takes approximately 0.16 hours (10 minutes) to notify broker-dealers pursuant to Rule 203(b)(3)(vi) of Regulation SHO.<sup>9</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 Rule 204(d). 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 applicable close-out date, the broker-dealer has to determine whether or not that portion of the fail to deliver position was closed out in accordance with Rule 204(a), we estimate that a broker-dealer will have to make such determination with respect to approximately 1.76 equity securities per day.<sup>10</sup>

We estimate a total of 2,466,415 notifications in accordance with Rule 204(d) across all broker-dealers (that will be allocated responsibility to close out a fail to deliver position) per year (5,561 broker-dealers notifying participants once per day<sup>11</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 compliance 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

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<sup>8</sup> Additionally, participants should already have in place mechanisms to comply with this requirement under temporary Rule 204T.

<sup>9</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

<sup>10</sup> As stated in the Rule 204T Adopting Release, the Commission's 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 National Securities Clearing Corporation ("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 multiplied 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. Rule 204T Adopting Release, 17 FR 61717, 61718 n. 107.

<sup>11</sup> Because failure to comply with the close-out requirements of Rule 204(a) is a violation of the rule, we believe that a broker-dealer would make the notification to a participant that it is subject to the borrowing requirements of Rule 204(b) at most once per day.

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 that the shares will be in the broker-dealer's physical possession or control by settlement date.<sup>12</sup> 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.<sup>13</sup> Participants will be able to use similar mechanisms, processes and procedures to demonstrate compliance with the 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.

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>14</sup> 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>15</sup>

We estimate a total of 1,687,896 demonstrations in accordance with Rule 204(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.

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<sup>12</sup> See 17 CFR 242.200(g)(1).

<sup>13</sup> 17 CFR 242.203(b)(1). Additionally, participants should already have in place mechanisms to comply with this requirement under temporary Rule 204T.

<sup>14</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 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.

<sup>15</sup> OEA estimates approximately 68% of trades are long sales and applies this percentage to the number of fail to deliver positions per day. OEA estimates that there are approximately 9,809 fail to deliver positions per settlement day. Across 197 broker-dealer participants of the NSCC, the number of securities per participant per day is approximately 50 equity securities. 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>.

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 receives 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 Rule 204(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>16</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; 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 requirements of Rule 203(b)(3)(iv) of Regulation SHO for threshold securities; and that participants will be able to continue to use the same communication mechanisms, processes and procedures to notify any broker-dealers from which they receive trades for clearance and settlement of the information required by the rule's notification requirement as they use for compliance with Regulation SHO.<sup>17</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>18</sup> 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 applicable close-out date the participant has to determine whether or not the fail to deliver position was closed out in accordance with Rule 204(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>19</sup>

We estimate a total of 2,482,200 notifications in accordance with Rule 204(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 @ 0.16 hours/documentation). We estimate

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<sup>16</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

<sup>17</sup> Additionally, participants should already have in place mechanisms to comply with this requirement under temporary Rule 204T.

<sup>18</sup> See supra note 14.

<sup>19</sup> See supra note 15.

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 a 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 Rule 204(e). We base this estimate, in part, on the fact that, to comply with the close-out requirements 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.<sup>20</sup> On average, participants informed us that such documentation takes approximately 0.16 hours (10 minutes).<sup>21</sup>

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. 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 Rule 204(e), we estimate that a broker-dealer will have to make such determinations with respect to approximately 1.76 securities per day. We estimate that on average, a broker-dealer will have to certify to the participant 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 Rule 204(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). 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-

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<sup>20</sup> Additionally, participants should already have in place mechanisms to comply with this requirement under temporary Rule 204T.

<sup>21</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.



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.<sup>22</sup> On average, participants informed us that such documentation takes approximately 0.16 hours (10 minutes).<sup>23</sup>

As of December 31, 2007, there were 5,561 registered broker-dealers. If a broker-dealer purchased or borrowed securities in accordance with the conditions specified in Rule 204(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 1.76 securities<sup>24</sup> per day.

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, 2,466,415 times per year (5,561 broker-dealers checking for compliance once per day on 1.76 securities, multiplied by 252 trading days in a year). The total approximate estimated annual burden hour per year will be approximately 394,626 burden hours (2,466,415 multiplied by 0.16 hours/demonstration). We estimate that the paperwork burden for compliance with the demonstration requirement of Rule 204(e)(4) for each broker-dealer will be approximately 71.0 burden hours per year.

### 13. Estimate of Total Annualized Cost Burden

The mechanisms necessary to comply with Rule 204 are the same as temporary Rule 204T. Thus, it is not anticipated that respondents will have to incur any capital or start up costs to comply with Rule 204 as participants should already have in place the mechanisms that were necessary to comply with temporary Rule 204T.

### 14. Estimate of Cost to the Federal Government

Not applicable.

### 15. Explanation of Changes in Burden

All collections of information from temporary Rule 204T have been incorporated into Rule 204 without modification, with the exception of the elimination in Rule 204 of the

<sup>22</sup> Additionally, participants should already have in place mechanisms to comply with this requirement under temporary Rule 204T.

<sup>23</sup> We base this estimate on information provided to our staff by three small, three medium, and three large registered clearing agency participants.

<sup>24</sup> The number of securities used in calculating the collection of information requirements for this provision was incorrectly stated as 1.20 securities in the Supporting Statement for temporary Rule 204T. We are amending this number to reflect our estimation in the Rule 204T Adopting Release, which is incorporated by reference into the Rule 204 adopting release, that a broker-dealer will have to make such determination with respect to approximately 1.76 securities per day, not 1.20 securities.

exception in temporary Rule 204T(b)(2) for market makers from the borrowing requirement in Rule 204(b). Such exception is no longer necessary under Rule 204(b) because, as with other broker-dealers, a market maker is excepted from the borrowing requirements of Rule 204(b) if it timely certifies to the participant 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 participant has a fail to deliver position at a registered clearing agency or that it is in compliance with the requirements of Rule 204(e). Because Rule 204(b) includes an exception applicable to all broker-dealers, including market makers, it was not necessary to maintain a separate exception applicable only to market makers.

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.