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RegSHO Rule 204

Optimizing compliance accuracy and efficiency



EXECUTIVE SUMMARY

This paper examines Regulation SHO (RegSHO) Rule 204 compliance and helps firms answer the following questions:

- How reliable are my current RegSHO Rule 204 processes in mitigating the risk of rule violations?
- Is my current RegSHO Rule 204 process optimal in terms of the amount of manual effort and operational strain involved in compliance?
- How can technology help to systematically improve RegSHO Rule 204 compliance?



BACKGROUND

WHAT IS RULE 204?

The SEC established RegSHO to combat naked short selling practices. An important component of RegSHO is Rule 204.

Rule 204:

- Mandates a strict adherence to delivery commitments related to sales of equity securities that settle at a registered clearing agency.
- Sets out standards of action the broker dealer needs to take when settlement does not occur within the expected timeframe.
- Defines a schedule for action in the event of a fail to deliver (FTD) on the scheduled settlement date.

The SEC implemented RegSHO in response to concerns about the operation of markets that could result in actual or the appearance of “naked short selling”. Driving RegSHO were events that included several market stresses, such as the collapse of the “dotcom bubble”. They were followed by a number of corporate and investor legal actions that arose in its wake.

RegSHO imposed a series of requirements on broker dealers who clear or facilitate short selling. This covers trading on their own accounts, or on behalf of other brokers or customers.

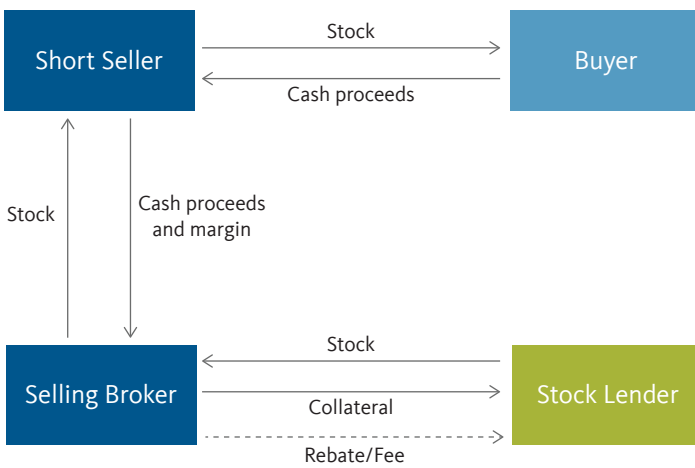
These requirements included:

- Stronger standards around transparency.
- The management of securities financing liquidity intended to reduce or eliminate fails to deliver (FTD).

'NAKED' SHORT SALES

A short sale is a leveraged transaction that needs to be financed to effect delivery to the buyer. This is most often through the utilization of broker margin excess availability under rule 15c3, or by the broker borrowing from a third party as in the example below:

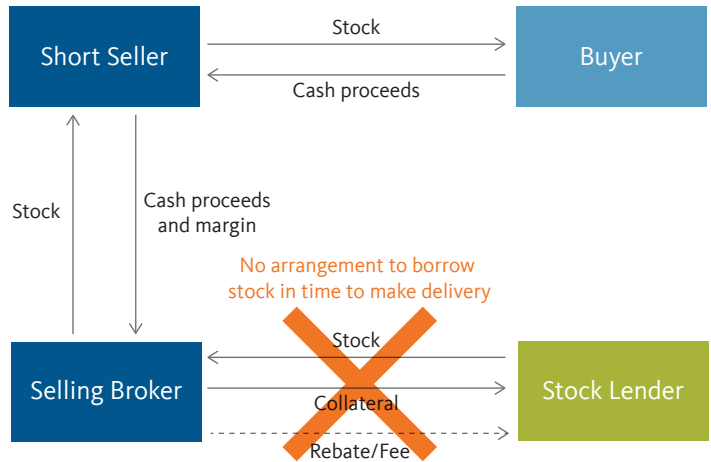
Short Sale Example



Naked Short Sale Example

In a “naked” short sale, the seller does not borrow or arrange to borrow the securities in time to make delivery to the buyer within the standard settlement period. Naked short selling – “actual or effective” - ultimately results in a fail to deliver (FTD).

One concern of the regulators is that until the seller and their broker finance the delivery, the short side investor and their broker avoid incurring their full share of the transactional exposure and cost in the strategy.



OBJECTIVES OF RULE 204 UNDER REGSHO

RegSHO codifies that reasonable steps are taken by the seller to ensure that delivery can be effected on settlement date prior to executing the sale. Secondly, it seeks to enforce the financing of the transaction when settlement is due.

The best way to think of Rule 204 is as the ultimate backstop to RegSHO. Most of RegSHO strives to prevent fails. Rule 204 under RegSHO addresses what happens when the measures taken up-front to avoid fails do not achieve that goal and answers the question: what happens when a Fail to Deliver (FTD) occurs?

Rule 204 aims to reduce or eliminate broker-dealer fails to deliver (FTD) to registered clearing agencies under the Continuous Net Settlement (CNS) program at the National Securities Clearing Corporation (NSCC).

The rule covers fails that may arise from short selling or across other activities that could have (or appear to have) the same negative effect on markets as naked short selling.

Further goals are to:

- Impose specific rules on the allowed duration of a FTD condition
- Define specific affirmative actions that must be taken by the broker dealer to clear an aged FTD
- Establish a series of penalties to the broker dealer and/or the broker dealer's customers for failure to comply.

VIOLATIONS OF RULE 204

Since establishing the Rule, regulators have found numerous violations, from minor to major. These have resulted in fines that range from tens of thousands to many millions of dollars. Regulators have also imposed painful sanctions and mandates for the more egregious findings.

Regulatory scrutiny of the Rule 204 process at a broker dealer can serve as the keyhole through which the regulator discovers other, more fundamental deficiencies in a broker's operations. These include the failure to supervise, violation of customer segregation rules, and books and records violations.

A key concern of the regulators, over and above specific instances of compliance or failure to comply, is the broker dealer's overall approach to compliance. This includes processes, procedures, controls, supervision and the effectiveness of supporting systems.

The table in Appendix 1 summarizes public filings by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).



FACTORS TO CONSIDER FOR COMPLIANCE

The complexity of managing compliance arises from a basic conflict between the requirements, and how settlement actually occurs in the real world.

TRACKING AND MANAGING FAILS TO DELIVER

A broker-dealer must track and manage a static snapshot of prior days' fails to deliver (FTD). This must include the cause of the FTD, and be tracked over multiple days. This also occurs within a settlement infrastructure that creates a moving target day over day by constantly netting new and aged delivery obligations together.

In other words, the close out requirements for aged FTD are based on a detailed level of record keeping per obligation, as though settlement occurred on a trade-by-trade basis. But the actual settlement mechanics blend all obligations into an undifferentiated and fungible whole.

ALLOCATION AND ATTRIBUTION OF FTD

At the same time, the FTD quantities on any given day must be allocated to specific types of trades or settlement activities within the aggregated FTD quantities at CNS. This can only be achieved by constant and ongoing review of trades and trade types settling today.

The FTD must then be attributed to their underlying cause. This requires the tracking of different attributed FTD quantity tranches until they have been entirely delivered to CNS.

The new FTD quantities must be distinct from the aged FTD quantities every day, within each attributed tranche.

The reduction in FTD quantity on a given day must be reported with details of the specific tranche from a specific prior date to which it applies. Supporting evidence must be kept and provided to examiners in order to back up the actions taken and the decisions made.

CLOSE OUT REQUIREMENTS

In meeting the close-out requirements, a broker-dealer may take the following FTD affirmative actions:

- Borrow the securities prior to market open on close out date
- Purchase the securities prior to market open on close out date. This results in the buy-in of the underlying trade(s) that caused the FTD, or a direct cost to trading desk if the broker chooses not to pass along the buy-in to their customer.

These affirmative actions must occur within a prescribed timeframe on a specific date. For this, broker-dealers must track the actions taken against FTD.

The following date-driven penalties also come into play when the FTD persists beyond the prescribed time. Commonly referred to as the "Penalty Box", they can include:

- Pre-borrow and pay-to-hold requirements for new short sales in the particular security
- Absolute restriction on the short-selling activity in that security by the broker-dealer or its customers
- Fines, sanctions, loss of trading privileges on repeated failures to comply with the rule.

Not only are these penalties disruptive for the broker-dealer's business, they can also impact their relationship with clients. Timely affirmative action is therefore essential.

FOOTNOTES, NO ACTION REQUESTS, COMMENTARY, AND INTERPRETATIONS

Like most rules governing securities markets, Rule 204 is replete with footnotes and interpretations. It is an on-going conversation between market participants and regulators in the form of no action requests and regulatory commentary.

The main thrust of the Rule is clear: to reduce or eliminate FTD through aggressive close out standards. The body of the Rule contains several close out deferral exemptions, recognizing that not all FTD are directly caused by short selling.

Examples are:

- For long sale activity which may have been used to finance customer margin debits under the re-hypothecation provisions of Reg T or Rule 15c3
- For market-maker activity
- For cases where sold shares may not be immediately available for delivery due to restrictions under other rules, such as rule 144a.
- Footnotes to the rule that deal with edge cases – such as fully paid lending and other securities not within the possession and control of the broker dealer.
- Provisions for “pre-fail credits” against short sales where a broker may avoid taking affirmative action on a FTD quantity. This may occur when a short is bought back between trade date and settlement date and delivery obligations are met through other means between the original settlement date and the “market open” on close out date.

What all these variations have in common is they further stress the broker dealer’s record keeping and reporting capabilities. They also highlight the inefficiencies associated in remaining compliant within the various permutations of the Rule.

Support personnel are often manually or semi-manually analyzing data. This makes it unrealistic to identify and document variable interpretations and edge cases that could reduce their close out requirements. Faced with strict deadlines in which all actions must be taken and proved before market open on close out date, timing is key.

CHALLENGES, COSTS AND RISKS IN COMPLIANCE

The challenges of managing and complying create costs and risks that fall into three inter-related categories:

- Complexity
- Record keeping and reporting
- Absorbing and allocating market costs

Though by no means a comprehensive list, some of the most common examples are summarized in the Table in Appendix 2.

For many broker dealers, the answer to this complexity is simple, “when in doubt, buy it in”. While this may avoid the risk of fines or regulatory findings of non-compliance, it does increase both hard and soft costs. It also does little to demonstrate the regulatory expectation that firms are managing Rule 204 in a well-controlled, well-supervised and systematic fashion.



DEFINING A MORE EFFECTIVE OPERATING MODEL

Many of these challenges arise from the basic approach to the problem, dealing with Rule 204 issues only after the FTD has occurred. This is usually on the morning after settlement date in the hours before market open.

The support team charged with compliance are therefore forced into making critical decisions within a short window of time. Good, methodical and systematic decision making seldom benefits from too little time to process and analyze data in the presence of ambiguity.

The more effective approach seeks to mitigate the issues of greatest cost, risk and regulatory concern by seeking to:

- Pre-analyze and report delivery obligations that could, on a future date, result in a Rule 204 close out requirement
- Pre-determine close out quantities and schedules before close out date, based on the underlying trade detail
- Systematically capture and report day-over-day, the data leading up to close out decisions
- Systematically and proactively track delivery obligations to the lowest level of trade detail
- Reduce human bias in the compliance decisions through the use of technology
- Remove ambiguity that can result in negotiation between trading desks, compliance and operations on close out date
- Reduce the time pressure on the morning of close out date, by allowing the data to be prepared and validated before it becomes a Rule 204 problem
- Provide flexibility based on the Rule, including footnotes, no action commentary and previous regulatory findings. This accounts for both current and future interpretations of compliance requirements
- Transform the morning of close out into simply an execution of procedure rather than a data analysis and decision making process.

HOW TECHNOLOGY CAN HELP

A purpose-built technology solution for RegSHO Rule 204 can provide significant improvements in productivity, while reducing the risk of non-compliance. It allows the firm to clearly demonstrate to regulators that it has a robust process for avoiding breaches and provides a clear audit trail, with full data traceability.

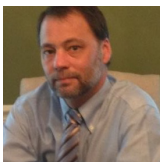
In a recent benefits realization exercise, a customer using Broadridge's RegSHO Rule 204 solution achieved an estimated 70% improvement in productivity. This was particularly the case around key compliance timeframes during the on-line day and resulted in a reduction in the morning compliance process from 4 man/hours to 45 minutes.

As a result, the client was able to shift resource scheduling due to a more efficient morning compliance process. This then reduced concerns about meeting daily deadlines and freed resources for other tasks later in the settlement day.

As more and more firms implement effective technology solutions for managing RegSHO, there is also a network effect as settlement discipline improves across the transaction chain. This results in exponential benefits for all participants.

If you find that the daily process of complying with RegSHO Rule 204 is stressful with a high degree of manual effort, perhaps it is time to look at putting a technological solution in place that reduces these headaches and mitigates the risk of expensive fines and reputational damage.

ABOUT THE AUTHORS



Rick Stinchfield is a senior consultant with Broadridge GTO Professional Services. He has spent over 30 years developing and managing capital markets industry-critical technologies, from some of the earliest start-up innovators

to major services providers and consultancies. He is a regular speaker at industry conferences and has been cited in financial industry publications and the mainstream press. He can be reached at richard.stinchfield@broadridge.com



Martin Seagroatt is the Global Marketing Director for Broadridge's securities finance and collateral management division. Previously he was Marketing Director at 4sight Financial Software. In June 2016 4sight was acquired

by Broadridge and the 4sight Securities Finance and Collateral Management System rebranded as the Broadridge Securities Financing and Collateral Management Solution.

In his 14 years in the industry he has specialized in securities lending, repo, and OTC/listed derivatives collateral management solutions. Prior to that Martin worked as a business expert in technology systems for risk management in the energy industry. He can be reached at: <https://www.linkedin.com/in/martinseagroatt/>.

ABOUT BROADRIDGE

Broadridge offers a suite of global, front to back office securities finance solutions for buy side and sell side. This includes integrated or standalone systems for Securities Lending, Repo, Collateral Management and Collateral Optimization, and an end to end transaction reporting solution for SFTR.

The Broadridge RegSHO 204 solution enables clients to analyze and manage common causes of Rule 204 FTD close out requirements through an integrated monitoring and close out platform.

The solution helps firms to reduce the risk of regulatory violations through clear workflow views. This allows users to automate much of the time consuming manual checks involved in remaining compliant through real time automated capture of settlement activity directly tied to RegSHO data. The solution also reduces the scope for human error and results in improved co-ordination between departments.

CONTACT INFORMATION

For further information on Broadridge's RegSHO 204 solution or Broadridge's Securities Finance and Collateral Management (SFCM) product suite please contact:

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APPENDIX 1: SEC FILINGS/FINDINGS

ISSUE	DESCRIPTION	REGULATORY BUSINESS RESULTS
Failures to take affirmative action to close out FTD	<ul style="list-style-type: none"> • Broker dealer did not take defined actions to close out specific aged FTD according to Rule 	<ul style="list-style-type: none"> • Fines • Increased frequency of reporting to regulator • Repeated ad hoc requests for information
Failure to impose trading restrictions	<ul style="list-style-type: none"> • Broker dealer did not self-impose trading restrictions (i.e., 'Penalty Box') on security with FTD • Did not require pre-borrow on short sales • Did not restrict automated or manual short sale approval 	<ul style="list-style-type: none"> • Larger fines • Increased frequency of reporting to regulator • Mandated systemic or procedural changes
Failure to allocate FTD and trading restrictions to correspondent broker or affiliate	<ul style="list-style-type: none"> • Broker dealer participant did not advise correspondent broker or affiliate (non-clearing) of 'Penalty Box' restriction on new short sales 	<ul style="list-style-type: none"> • Larger fines, increased frequency of reporting to regulator • Loss of clearing relationship with correspondent • Findings of failure to supervise, mandated system or procedural changes

ISSUE	DESCRIPTION	REGULATORY BUSINESS RESULTS
<p>Questionable or unjustified application of close out deferral ('long sale exemption')</p>	<p>Broker dealer exempted FTD from immediate close out according to Rule by deferring the close out date according to the long sale exemption without providing sufficient evidence they were eligible to take the exemption</p>	<ul style="list-style-type: none"> • Larger fines • Increased frequency of reporting to regulator • Deeper scrutiny into record keeping practices, associated fines for failure to comply with other 'books and records' rules • Findings of failure to supervise, mandated system or procedural changes
<p>Excessive human bias in compliance to and application of the Rule favoring trading revenue over compliance</p>	<p>Broker dealer lacked systemic approach to FTD monitoring, determination of close out requirements, decision making and internal controls over process</p> <p>Excessive influence of business and trading over compliance decisions</p>	<ul style="list-style-type: none"> • Major fines and sanctions, imposition of regulatory supervision over procedural and systemic changes, restrictions on trading activities • Findings of lack of supervision and separation of duties

APPENDIX 2: CHALLENGES, COSTS AND RISKS

CHALLENGE	COST	RISK
Accurately determining FTD subject to Rule 204 close out today	<ul style="list-style-type: none"> Data accumulation and analysis 	<ul style="list-style-type: none"> Failure to accurately determine and report quantities can result in fines
Accurately determining FTD that can be deferred to a later date by Rule	<ul style="list-style-type: none"> Broker may unnecessarily take premature affirmative action (buy or borrow) at increased cost to trading desk and/or customer 	<ul style="list-style-type: none"> Inability to properly document and justify close out deferral to regulators can result in fines, sanctions
Allocating FTD to underlying trading activity that caused the FTD according to different conditions/interpretations under rule	<ul style="list-style-type: none"> Data accumulation and analysis Allocation of cost to underlying customer or trading desk 	<ul style="list-style-type: none"> Inaccurate allocation can result in miscalculation of close out date Books and records deficiencies Fines
Allocating reductions to FTD over time before close out date according to different conditions/interpretations under rule	<ul style="list-style-type: none"> Data accumulation and analysis High degree of reporting and justification 	<ul style="list-style-type: none"> Risk of human bias influencing calculations in favor of trading desk or customer Failure to supervise Fines and sanctions
Avoiding “double counting” of credits against FTD quantities; failure to systematically account for reductions by tranche	<ul style="list-style-type: none"> Data accumulation and analysis High degree of reporting and justification 	<ul style="list-style-type: none"> Potential to understate current FTD requiring close out Failure to supervise Books and records deficiencies Fines
Allocation of buy and borrow costs to underlying trading activity	<ul style="list-style-type: none"> Hard costs in price differences on buys; Financing costs on borrows 	<ul style="list-style-type: none"> Risks of negotiation between desks and operations/ compliance influencing close out decisions Failure to supervise Fines
Compressed timeframe to determine affirmative action before market open	<ul style="list-style-type: none"> Over borrow or over buy to avoid “penalty box” 	<ul style="list-style-type: none"> More sophisticated analysis may not be feasible in time available Attempts to mitigate subject to regulatory scrutiny Could be subject to error Fines

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