

# NASD Notice to Members 98-65

## NASD Reminds Members Of Obligations Relating To The Short- Sale Rule

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### Executive Summary

In 1994, the National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 3350 (Short-Sale Rule) was adopted to stop market-destabilizing speculative short sales in Nasdaq National Market<sup>®</sup> (NNM) securities. To prevent this conduct, the Short-Sale Rule prohibits member firms from executing customer short sales and non-Market Maker proprietary short sales in an NNM security at or below the current inside bid when the current inside bid is lower than the previous inside bid.

It has come to the attention of NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) that certain NASD members may be assisting customers in the circumvention of this Rule.

Specifically, these members are failing to net security positions of related accounts for customers who maintain accounts in their name and exercise control over a second related account, usually held in a family member's name. The failure to net these positions has permitted these customers, which operate the two accounts with a single investment strategy, to avoid application of the Short-Sale Rule.

Members are required to net all positions for accounts that are related or under common control in order to determine whether a sale is long or short and subject to the Short-Sale Rule requirements. NASD Regulation is committed to ensuring strict adherence to the Short-Sale Rule and will carefully review whether firms have engaged in the conduct described in this *Notice* in examinations and investigations. Violations of the Short-Sale Rule will be vigorously pursued.

Questions concerning this *Notice* should be directed to David Katz, Assistant Chief Counsel, Market Regulation, NASD Regulation, at (301) 208-3074.

### Overview

The NASD adopted the Short-Sale Rule to prevent speculative short selling in NNM securities from accelerating a decline in the price of a security and to stop a form of manipulation known as "bear raiding" or "piling on." Piling on occurs when short sellers exert pressure on a stock's price, forcing the price to drop precipitously, frequently within a single trading day. The Short-Sale Rule prohibits member firms from executing customer short sales and non-Market Maker proprietary short sales in an NNM security at or below the current inside bid when the current inside bid is lower than the previous inside bid.<sup>1</sup>

To determine whether a sale is long or short, members must adhere to the definition of a "short sale" contained in the Securities and Exchange Commission (SEC) Rule 3b-3, which is incorporated into the NASD's Short-Sale Rule. Under SEC Rule 3b-3 and NASD Rule 3350, the term "short sale" means any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. To determine whether the seller is long or short overall, the seller must net all positions in the security. This includes netting positions held in accounts that are related or under common control.

### Rule Prohibits Circumvention

The Short-Sale Rule also prohibits a member from knowingly, or with reason to know, effecting sales for the account of a customer or for its own account for the purpose of avoiding the rule.<sup>2</sup> With this *Notice*, the NASD wishes to clarify that a member would be deemed to be in violation of the Short-Sale Rule if the member or an associated person knowingly assists customers in

the following scheme:

- A customer maintains one account (a "long account") that is used to buy and sell various securities several times in a single day. The long account typically begins and ends each day with a long position of 1,000 shares in each security held in that account. The customer also cross guarantees for Regulation T and margin purposes a second account (a "short account"), usually held by a family member or related person. That account holds offsetting short positions of 1,000 shares in the same securities that are held in the long account. In contrast to the long account, the short account generally does not change positions in the securities. At the beginning and end of each day, the combined positions in both accounts for each of the securities is flat. During the trading

day, the customer buys and sells securities out of the long account, creating the false appearance of alternating long and flat positions in the securities in the long account. When the two accounts are appropriately combined and treated as one, short sales occur on a regular basis and often result in transactions occurring on downbids in violation of the NASD's Short-Sale Rule.

NASD Regulation will view trades in accounts like those described above as occurring in related or controlled accounts and must be netted for purposes of compliance with the Short-Sale Rule. Accounts will be deemed to be related or controlled if the customer exercises discretion over the account, cross guarantees the account for Regulation T or margin purposes, or has been granted a power of attorney to execute transactions in the account. NASD Regula-

tion will also consider other facts and circumstances such as whether the account belongs to a family member or related person and whether a similar pattern of activity is occurring in other customer accounts.

NASD Regulation will closely watch for the above described conduct and for similar schemes that attempt to circumvent application of the Rule. Members should instruct their associated persons not to accept orders for execution where customers are operating two accounts in order to avoid the Rule. A finding of such abuses will result in possible disciplinary action.

## Endnotes

<sup>1</sup> NASD Rule 3350(a).

<sup>2</sup> NASD Rule 3350(e).

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