

Notice to Members

DECEMBER 2004

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Registered Representatives
Senior Management
Systems
Trading
Training

KEY TOPICS

OATS
Rule 3110
Rule 3210
Rule 3350
Rule 3370
Rule 11830
Rules 6950 - 6957
Short Sales

GUIDANCE

Short Sale Requirements

Issues Relating to the SEC's Adoption of Regulation SHO

Executive Summary

On June 23, 2004, the Securities and Exchange Commission (SEC) adopted certain provisions of a new short sale regulation, designated Regulation SHO.¹ Regulation SHO consists of new Rules 200 (definitional and order marking requirements), 202T (short sale price test pilot) and 203 (uniform locate and delivery requirements). Together with the Regulation SHO adopting release, the SEC issued an order establishing a one-year pilot suspending the provisions of SEC Rule 10a-1(a) and any short sale price test of any exchange or national securities association for short sales of certain securities for certain time periods (Pilot).²

NASD, in conjunction with The Nasdaq Stock Market, Inc. (NASDAQ), is issuing this *Notice to Members* to advise member firms and other interested parties of several recent actions and related guidance surrounding the adoption of Regulation SHO. First, on November 30, 2004, NASD filed for immediate effectiveness a proposed rule change to repeal NASD Rule 3110(b)(1),³ Rule 3210,⁴ Rule 3370(b)⁵ and Rule 11830,⁶ which are duplicative of or overlap with the uniform requirements of Regulation SHO. The repeal of these rules will be operative on January 3, 2005, the compliance date of Regulation SHO. Second, NASD and NASDAQ staff are providing information and guidance on several issues relating to Regulation SHO. Questions and answers have been provided relating to the Order Audit Trail System (OATS) rules, the application of Rule 3350 (the Short Sale Rule), the publication and dissemination of the "threshold list" required by Regulation SHO and excused withdrawal status for market makers that cannot comply with the Regulation SHO pre-borrow requirements. Third, NASD is highlighting the recent questions and answers published by the SEC relating to Regulation SHO and is encouraging members to review this

guidance prior to the January 3, 2005 Regulation SHO compliance date. Finally, NASD is emphasizing that it will be closely monitoring member activity for compliance with the Regulation SHO requirements and, in this regard, members must have supervisory procedures and systems in place designed to ensure compliance with these requirements.

Questions/Further Information

Questions regarding this *Notice* may be directed as follows: For questions regarding the repeal of NASD rules, contact the Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8071 or the Legal Section, Market Regulation, NASD, at (240) 386-5126; for questions regarding OATS Reporting, please contact the OATS Help Desk at (800) 321-NASD; for questions regarding Rule 3350 and market maker excused withdrawals, contact Office of General Counsel, The Nasdaq Stock Market, Inc., at (301) 978-8400; and for questions regarding Threshold List Securities, direct them to traderreports@nasdaq.com or Market Operations, NASD, at (866) 776-0800.

Discussion

Repeal of NASD Short Sale Rules in Light of Regulation SHO

Several existing NASD rules are duplicative of or overlap with the new provisions of Regulation SHO, including: (1) SEC Rule 200(g) of Regulation SHO, which requires that sell orders in all equity securities be marked "long," "short," or "short exempt"; (2) SEC Rule 203(a) of Regulation SHO, which provides that, with certain limited exceptions, if a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so; (3) SEC Rule 203(b)(1) of Regulation SHO, which applies a uniform rule, with certain limited exceptions, requiring all broker-dealers, prior to effecting short sales in equity securities, to "locate" securities available for borrowing; and (4) SEC Rule 203(b)(3) of Regulation SHO, which requires registered clearing agency participants to close out all failures to deliver 10 days after the normal settlement date for securities in which a substantial amount of failures to deliver have occurred, referred to as "threshold securities."

As noted in the adopting release for Regulation SHO, as well as in discussions between SEC and NASD staff, the SEC has indicated that Regulation SHO provisions will replace existing overlapping self-regulatory organization (SRO) rules. As a result, on November 30, 2004, NASD filed for immediate effectiveness a proposed rule change to repeal NASD Rule 3110(b)(1), Rule 3210, Rule 3370(b) and Rule 11830 in light of the requirements of Regulation SHO. The repealed NASD rules will be supplanted by Rule 200(g) and Rule 203 of Regulation SHO, which will provide uniform order marking and locate and delivery requirements applicable to all equity securities. The compliance date of the repeal of these rules is January 3, 2005, the compliance date for Regulation SHO.

Questions and Answers Relating to NASD Rules and Procedures

To help members in the implementation of Regulation SHO and the Pilot, NASD and NASDAQ staff have published the following questions and answers relating to NASD rules and procedures that are affected by Regulation SHO:

OATS Requirements

Q: What are our OATS reporting requirements relating to short sales in light of Regulation SHO?

A: As noted in the OATS Technical Specifications, the buy/sell code for OATS reports should be populated to indicate whether an order is a long sale (SL), a short sale (SS) or a short sale exempt (SX).⁷ These codes should be populated and reported to OATS consistent with the order marking requirements under Regulation SHO and as is currently required under certain NASD rules, such as Rule 3350. For example, to the extent a short sale order is deemed exempt under Rule 202T of Regulation SHO or Rule 3350, the order should be marked as such for purposes of OATS reporting requirements. To the extent that the SEC permits members to mark orders that are exempt under Regulation SHO with a “short sale” indicator rather than a “short sale exempt” indicator, OATS information should be populated consistent with SEC guidance.

Rule 3350

Q: Did the adoption of Regulation SHO have any impact on the application of NASD Rule 3350?

A: Reg SHO suspends the application of the bid test under NASD Rule 3350 for those stocks that are subject to the short sale price test pilot under SEC Rule 202T. NASDAQ recently amended Rule 3350 to create an exemption for those pilot securities. View the rule filing at www.nasdaq.com/about/SR-NASD-2004-187_NASDAQ_Rule_Filing.pdf.

Regulation SHO Threshold at Securities

Q: What is a threshold security for purposes of Regulation SHO?

A: As defined in Rule 203(c)(6) of Regulation SHO, a “threshold security” is any equity security of any issuer that is registered under Section 12 of the Exchange Act, or that is required to file reports under Section 15(d) of the Exchange Act (commonly referred to as reporting securities), where, for five consecutive settlement days:

- ▶ there there are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per security;
- ▶ the the level of fails is equal to at least one-half of one percent of the issue’s total shares outstanding; and

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- ▶ the security is included on a list published by a self-regulatory organization (SRO).

A security ceases to be a threshold security if it does not exceed the specified level of fails for five consecutive settlement days.

Q. What is the NASDAQ Threshold Securities List?

- A. The NASDAQ Threshold Securities List is the list of threshold securities published by NASDAQ to comply with Rule 203(c)(6) of Regulation SHO.

Q. What are the Market Categories of issues that the NASDAQ List will include?

- A. The NASDAQ list will include NASDAQ National Market and NASDAQ Small Cap securities as well as OTCBB issues and other OTC equity issues.

Q. How can I access the NASDAQ Threshold Securities List?

- A. The List will be posted on *www.nasdaqtrader.com* in three different ways.
- ▶ Each night prior to 12:00 midnight ET, the List will appear on the NASDAQ Trader Web site in HTML format at *www.nasdaqtrader.com/asp/regsho.aspx*.
 - ▶ A text file will be published on the Web site at *www.nasdaqtrader.com/dynamic/symdir/regsho/Nasdaqthyyymmdd.txt*.
 - ▶ The same text file will be published on the *www.nasdaqtrader.com* FTP site at: *ftp://ftp.nasdaqtrader.com/symboldirectory/regsho/Nasdaqthyyymmdd.txt* for those firms wishing to automate the extract.

Q. What will be the format of the file?

- A. The format of the file will be as follows: Symbol/Security Name/Market Category/Reg SHO Threshold Flag/Filler/Filler. The values for the Market Category will be as follows:

- Q NASDAQ National Market (NNM)
- S Small Cap NASDAQ
- U OTCBB
- u Other OTC

Q. What does the date in the filename mean?

A. The date in the filename reflects the settlement date that the data is based on.

For example, the filename for the file posted containing January 7, 2005 settlement date data will be Nasdaqth20050107.

Q. How can I tell what time the list was created?

A. The end of the data file will contain a File Creation Timestamp, reflecting the date and time the file is complete. The Timestamp will be in the following format: `yyyymmddhhmmss`.

Q. How much history will NASDAQ maintain?

A. NASDAQ will not delete any files. A full history of files will be available on the FTP site. The daily text file on the website can be obtained by manipulating the url in the browser address field (by manually changing the "mmdd" in the filename URL).

Q. What if the List is posted late (after 12:00 midnight ET) on the NASDAQ Trader Web site?

A. According to guidance provided by staff of the SEC Division of Market Regulation, firms will be permitted to use the previous settlement day's List to comply with Regulation SHO, if the file is unavailable by 12:00 midnight ET. Firms are still obligated to analyze the current settlement day's data when it becomes available to determine compliance with Regulation SHO's close-out requirement.

Q. Starting on what date will the NASDAQ Threshold Securities List be posted?

A. As stated above, Rule 203(c)(6) of Regulation SHO defines "threshold security" as one that exceeds a level of fails for five consecutive settlement days. Since the new rule takes effect on January 3, 2005, the first date a security can meet this definition will be five settlement days after the effective date. Accordingly, the first List will be posted before midnight on Friday, January 7, 2005, and will be available before the opening of trading on Monday, January 10, 2005.

Q. Where can I get more information relating to the NASDAQ Threshold List?

A. A General News item was posted at the following Web site: www.nasdaqtrader.com/Trader/News/2004/generalnews/20041209.stm.

Excused Withdrawals Relating to Compliance with Regulation SHO's Pre-Borrow Requirements

Q. What impact will Regulation SHO's pre-borrow requirement have on a market maker's ability to make a market in a threshold security?

A. Rule 203(b)(3)(iii) of Regulation SHO (pre-borrow requirement) states that a clearing agency participant that has a fail to deliver position in a threshold security for 13 consecutive settlement days may not accept a short sale in the security, or enter a short sale in the security for its own account, without borrowing, or entering into a bona fide arrangement to borrow, the security, until the participant closes out the fail to deliver position by purchasing securities. This pre-borrow requirement also applies to any broker-dealer for which a clearing agency participant clears, including market makers that otherwise would be entitled to rely on the bona-fide market making exception from Rule 203(b)(1)'s locate rule. Thus, if a threshold security is not borrowable, the SEC Division of Market Regulation staff has acknowledged that the application of the pre-borrow requirement may result in a market maker's failure to make markets in that security because of its inability to effect further short sales until the fail to deliver position is closed out. Nasdaq has concluded that a market maker's failure to make a market in the security under these circumstances can form the basis for an excused withdrawal under Rule 4619, which would allow the market maker to resume making markets once the fail to deliver position is closed out or the security becomes borrowable.

SEC Guidance on Regulation SHO Implementation Issues

To assist in the understanding and application of Regulation SHO and the Pilot, SEC staff has published questions and answers regarding Regulation SHO, which are available on the SEC's website at <http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm>. SEC staff notes that the responses in the questions and answers may vary depending on certain facts and circumstances of a particular transaction and that SEC staff may update the questions and answers periodically.

Among other important issues, Question 4.1 of the SEC's guidance addresses satisfying the "reasonableness" standards of the locate rules. Specifically, Rule 203(b)(1)(ii) permits a broker or dealer to accept a short sale order in an equity security if the broker-dealer has reasonable grounds to believe that the security can be borrowed so that it can be delivered on settlement date. "Reasonableness" is determined based on the facts and circumstances of the particular transaction and the SEC provided examples

of reasonableness in its Adopting Release. For example, footnote 58 of the Adopting Release notes that a broker-dealer may obtain an assurance from a customer that such party can obtain securities from another identified source in time to settle the trade. In this regard, members must be able to demonstrate that there are reasonable grounds to rely on such customer assurances that they can obtain securities, for example, through documentation noting the source of securities cited by the customer and demonstrating that previous borrowings arranged by the customer resulted in timely deliveries in settlement of the customer's transactions. As such, where a member knows, or has reason to know, that a customer's prior assurances resulted in failures to deliver, assurances from such customer would not satisfy the reasonableness determination of SEC Rule 203(b)(1)(ii) of Regulation SHO.

The SEC's guidance also addresses several other important issues, including clarification on the marking requirements for OTC Bulletin Board Securities (Question 2.1), the use of Easy to Borrow Lists (Question 4.2), and reliance on customer representations to comply with the locate requirements (Question 4.3). NASD encourages members and other interested parties to review the SEC's published guidance.

Surveillance and Examination of Regulation SHO Requirements

NASD will be closely monitoring member activity for compliance with the Regulation SHO requirements and members will be expected to be in compliance with the Regulation SHO requirements as of the January 3, 2005 compliance date. Among other things, NASD is developing surveillance programs that will track the level and duration of CNS fails by members. To the extent such fails are not closed out within the requisite time period, NASD will be reviewing the actions taken by the member to close out the fails, which should be clearly documented by the member. Similarly, NASD will be reviewing member activities to ensure that members have complied with the marking, locate, and pre-borrow requirements, as applicable. Accordingly, NASD's member examination program will include reviews for compliance with each applicable rule in Regulation SHO.

In addition, NASD Rule 3010 requires that members establish and maintain a supervisory system that is designed to ensure compliance with the NASD rules and the federal securities laws. Accordingly, NASD will be examining closely members' supervisory systems and written supervisory procedures relating to Regulation SHO and, where appropriate, will initiate disciplinary action against firms and their supervisory personnel for failure to adopt, implement, and enforce appropriate supervisory procedures.

Endnotes

- 1 See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (Adopting Release).
- 2 See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004) (Pilot Order). See *also* Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004) (Second Pilot Order).
- 3 Rule 3110(b)(1) requires that an associated person indicate on the order ticket whether an order is "long" or "short."
- 4 Rule 3210 prohibits a member from selling a security for its own account or buying a security as a broker for a customer, if the member has a fail to deliver in that security that is 60 days old or older, or 90 days old or older for foreign securities.
- 5 Rule 3370(b) requires, among other things, that (1) no member accept a long sale order from a customer unless the member has possession of the security, the customer is long in his account, the member makes an affirmative determination that the customer owns the security and will deliver it on settlement date or that it is in good deliverable form on deposit with a member or other permissible entity; and (2) no member effect a "short" sale order for a customer, non-member broker-dealer or proprietary account in any security unless the member makes an affirmative determination that the member will receive delivery of the security or that the member can borrow the security for delivery by settlement date, subject to certain exemptions.
- 6 Rule 11830 generally mandates delivery of a security within 10 days of the settlement date for short sales executed in NASDAQ securities that, on the trade date of the transaction, had a clearing short position equal to at least one-half of one percent of the issue's total shares outstanding.
- 7 The OATS Technical Specifications are available at www.nasdaq.com/oatsspecifications.

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