

Notice to Members

APRIL 2005

SUGGESTED ROUTING

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

KEY TOPICS

Order Audit Trail System (OATS)
Order Marking
SEC Regulation SHO
Short Sales

GUIDANCE

Issues Relating to the SEC's Adoption of Regulation SHO

Short Sales in Pilot Securities and Order-Marking Requirements under SEC Regulation SHO

Executive Summary

NASD, in conjunction with The Nasdaq Stock Market, Inc. (NASDAQ), is issuing this *Notice to Members* (NTM) to advise member firms and other interested parties of certain actions and issues surrounding the adoption of Regulation SHO by the Securities and Exchange Commission (SEC). First, on January 3, 2005 and April 15, 2005, the staff of the SEC Division of Market Regulation issued two No-Action Letters granting relief from the order-marking requirements under Regulation SHO in certain circumstances. In this regard, NASDAQ has established a "masking" process, as described in the SEC's April 15, 2005, No-Action Letter. Second, NASD wishes to remind members using their own proprietary or vendor order management systems to accept and execute short sales in Regulation SHO pilot securities that such members are responsible for making appropriate system changes to ensure proper handling of pilot securities. In this regard, NASD is encouraging such members to review and test their systems to ensure readiness for the May 2, 2005, Regulation SHO pilot order effective date. Finally, with respect to Order Audit Trail System (OATS) requirements, members also may mark their OATS report consistent with the SEC's order-marking relief.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8071; the Legal Section, Market Regulation, NASD, at (240) 386-5126; or the Office of General Counsel, The Nasdaq Stock Market, Inc., at (301) 978-8400.

Discussion

As further detailed in *NTM 04-93*, the SEC recently adopted certain provisions of a new short sale regulation, designated Regulation SHO.¹ Regulation SHO consists, among other provisions, of new SEC Rule 200(g) (order-marking requirements) and new SEC Rule 202T (short sale price test pilot). SEC Rule 200(g) of Regulation SHO requires that sell orders in all equity securities be marked "long," "short," or "short exempt."² SEC Rule 202T established a procedure for the SEC to suspend on a temporary basis the operation of SEC Rule 10a-1(a) and any short sale price test of any exchange or national securities association for those securities designated by SEC order. Together with the Regulation SHO adopting release, the SEC issued an order (Pilot Order) establishing a one-year pilot (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 Securities).³ Short sales of Pilot Securities effected during the Pilot should be marked "short exempt."

The Pilot was originally scheduled to commence on January 3, 2005, and end on December 31, 2005. However, a large number of broker-dealers notified the SEC that it would be inefficient and very costly for them to comply with the order-marking requirements for Pilot Securities because of the significant systems changes necessary to ensure proper marking. Further, broker-dealers raised concerns that these systems changes may be in effect only for the one-year Pilot. To assist firms with these issues and concerns, the market centers agreed to "mask" the short sale character of any short sale orders in Pilot Securities so they are executed as short exempt. To allow adequate time for market centers to make necessary programming changes in this regard, the SEC issued a second pilot order postponing the one-year Pilot to commence on May 2, 2005, and end on April 28, 2006.⁴

SEC No-Action Relief

On January 3, 2005, SEC staff issued a No-Action Letter to grant relief from the order-marking requirements of SEC Rule 200(g) of Regulation SHO in certain circumstances. The letter provides that SEC staff will not recommend enforcement action under SEC Rule 200(g) of Regulation SHO against a broker-dealer that marks "short," rather than "short exempt," a short sale effected in certain specified classes of securities or during certain specified time periods that are exempt from the provisions of SEC Rule 10a-1(a) or any short sale price test of any exchange or national securities association as set forth in the No-Action Letter. The No-Action relief is subject to certain conditions described in the letter, including without limitation, that in no event will broker-dealers executing exempt short sales be allowed to mark such sales "long." A copy of the letter is available on the SEC's Web site at [mr-noaction www.sec.gov/divisions/market/reg/mr-noaction/sia010305.htm](http://mr-noaction/www.sec.gov/divisions/market/reg/mr-noaction/sia010305.htm).

In addition, on April 15, 2005, SEC staff issued a No-Action Letter granting further relief from the order-masking requirements. Specifically, this letter provides that SEC staff will not recommend enforcement action against a broker-dealer that marks "short" rather than "short exempt" a short sale effected in any Pilot Security where the broker-dealer, among other things, routes the orders to a market center that has a "masking" process in place. A copy of the letter is available on the SEC's Web site at www.sec.gov/divisions/marketreg/mr-noaction/sia041505.htm.

NASD encourages members and other interested parties to review both No-Action Letters, including the specific conditions of the relief. Additional guidance and information about the Pilot and order-marking requirements are available on the SEC's Web site at www.sec.gov/spotlight/shopilot.htm.

Short Sales in Pilot Securities

Upon commencement of the Pilot on May 2, 2005, orders in NASDAQ-listed and exchange-listed Pilot Securities (including orders entered prior to and remaining open as of May 2, 2005) entered into the NASDAQ Market Center execution system will not be subject to a price test. Broker-dealers that use a proprietary or vendor order management system to execute orders internally must ensure that the appropriate system changes are completed prior to May 2, 2005 such that sell short orders in Pilot Securities are handled and executed in accordance with Regulation SHO. In particular, broker-dealers must ensure that internalized sell short orders in Pilot Securities are executed without the application of a price test. Accordingly, NASD encourages member firms that use such systems to test these systems to ensure proper handling of Pilot Securities.

Upon commencement of the Pilot on May 2, 2005, and for the duration of the Pilot, broker-dealers may mark sell short orders in Pilot Securities "short" instead of "short exempt" when entering them into the NASDAQ Market Center execution system. The NASDAQ Market Center execution system will not perform a short sale validation of sell short orders in Pilot Securities, regardless of whether such orders entered into the NASDAQ Market Center execution system are marked "short" or "short exempt."

Similarly, for purposes of OATS reporting, members may mark orders and transactions in Pilot Securities as "sell short," if appropriate, rather than "sell short exempt." Members are reminded, however, that this guidance is limited to orders and transactions covered by the SEC's No-Action relief. For example, short sale transactions that qualify for other exemptions under Rule 3350 or SEC Rule 10a-1, such as the market maker exemption, must continue to be marked as "short sale exempt."

Endnotes

- 1 See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).
- 2 The compliance date for SEC Rule 200(g) of Regulation SHO was January 3, 2005.
- 3 See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004) (Pilot Order). The Pilot Order suspends the price tests for: (1) short sales in the stocks identified in Appendix A of the Pilot Order; (2) short sales in any security included in the Russell 1000 index effected between 4:15 p.m. EST and the open of the consolidated tape on the following day; and (3) short sales in any security not included in paragraphs (1) and (2) above effected in the period between the close of the consolidated tape and the open of the consolidated tape the following day.
- 4 See Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004) (Second Pilot Order).

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