

Notice to Members

MARCH 2004

SUGGESTED ROUTING

Executive Representative
Legal & Compliance
Operations

KEY TOPICS

NASD Rule 3370
Short Sale Rule
Affirmative Determination

GUIDANCE

Affirmative Determination Requirements

NASD Provides Further Guidance on Amendments to NASD Rule 3370—Affirmative Determination Requirements

Executive Summary

On November 14, 2003, the Securities and Exchange Commission (SEC) approved amendments to Rule 3370 (Prompt Receipt and Delivery of Securities—the “affirmative determination requirements”) that expand the scope of the affirmative determination requirements to include orders from non-member broker-dealers.¹ On February 18, 2004, NASD delayed the effective date of these amendments to April 1, 2004, to provide additional time to permit members to make technological changes to their systems to comply with the new requirements.² In this *Notice*, NASD staff is providing additional guidance to assist members in their implementation of the new amendments.

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Regulatory Policy and Oversight (RPO), at (202) 728-8104; or Patricia M. Albrecht, Assistant General Counsel, RPO, (202) 728-8026.

Background and Discussion

Under the new amendments to Rule 3370, members now are responsible for making an affirmative determination when receiving orders from non-member broker-dealers. Members have sought clarification concerning the scope of these new responsibilities, including whether orders received in response to a quote displayed on an inter-dealer quotation system, exchange, or other quotation medium would trigger the requirements under the Rule.

NASD Rule 3370(b)(2) states that a member may not accept a short sale order from a customer or non-member broker-dealer unless it has made an affirmative determination that it will receive delivery of the security from the customer or non-member broker-dealer or that the member can borrow the security on behalf of the customer or non-member broker-dealer for delivery by settlement date. NASD staff is clarifying that the amendments to the affirmative determination requirements apply to all orders from non-member broker-dealers, whether received manually via the telephone or electronically. The amendments, however, would not apply to those orders executed by the member as an arm's length transaction. It is NASD staff's view that arm's length transactions are defined by the absence of a commercial relationship between the non-member broker-dealer and the member. Thus, the following relationships would not be considered arm's length: (1) arrangements in which a non-member broker-dealer's order flow is sent to a member; (2) pre-existing understandings between a non-member broker-dealer and a member regarding the execution of orders; (3) reciprocal business arrangements between a non-member broker-dealer and a member; (4) *de facto* relationships between a non-member broker-dealer and the member evidenced by the pattern or volume of order flow; or (5) any instance where an order sent by a non-member broker-dealer is to be handled or "worked" by a member. Furthermore, an arm's length transaction is not necessarily determined on an order-by-order basis. Members are cautioned that execution of an order from a non-member broker-dealer against its displayed quote may not be deemed an arm's length transaction if the totality of the circumstances of the relationship between the member and the non-member broker-dealer indicate a commercial relationship.³ The concept of an arm's length transaction is intended to draw a distinction between those situations in which the member is acting merely as the buyer—as opposed to the facilitator—in respect of a non-member broker-dealer's order flow.

NASD also wishes to clarify that any member operating an electronic communications network (ECN) or alternative trading system (ATS) shall be responsible for ensuring compliance with Rule 3370 with respect to orders, if any, executed by non-member broker-dealers on or through the ECN or ATS.

Lastly, NASD wishes to remind members that, under the affirmative determination requirements, the information necessary for a member to make an affirmative determination must be provided on an order-by-order basis. A member may not rely on a blanket representation from a non-member broker-dealer or customer that all orders it provides are long sales or that it otherwise has met the affirmative determination requirements. In addition, while a member may rely on assurances from a non-member broker-dealer or customer that such party can deliver the securities within three business days to the member (or on the member's behalf where the member has subsequently sold the securities to a third party),⁴ a member may only do so when such reliance is reasonable. For example, where a member knows or has reason to believe that a non-member broker-dealer's or customer's prior assurances resulted in a failure to deliver, continued reliance on assurances from such non-member broker-dealer or customer may not be reasonable. Accordingly, in those situations, a member would be required to meet its affirmative determination requirements by locating the stock before accepting a short sale order.⁵

Endnotes

- 1 File No. SR-NASD-2001-85; SEC Release No. 34-48788 (Nov. 14, 2003); 68 F.R. 65978 (Nov. 24, 2003); See *NASD Notice to Members 04-03* (January 2004).
- 2 File No. SR-NASD-2004-031, SEC Release No. 34-49285 (Feb. 19, 2004); 69 F.R. 8717 (Feb. 25, 2004); See *NASD Notice to Members 04-08* (February 2004).
- 3 Accordingly, in circumstances where (i) a non-member broker-dealer may seek to execute against a member's displayed quote, (ii) such transaction would not be viewed as an arm's length transaction, and (iii) the member does not have the capacity to handle such automated or phoned orders in a manner that comports with both their obligations under Rule 3370 and the firm quote obligations of Rule 3320, the member should consider avoiding counterparty trading relationships with non-member broker-dealers in favor of accepting orders on a handled-basis where the member could comply with Rule 3370. It shall not be deemed a violation of Rule 3320 for a member, in response to an order from a non-member broker-dealer seeking to execute against the member's displayed quote, to reject the order based on the fact that such member will only accept such order flow on a handled-basis, provided that, (i) the member makes such restriction known to the non-member broker-dealer promptly upon receipt of the order; (ii) this restriction applies to all orders of the non-member broker-dealer and is not applied on an order-by-order basis; and (iii) such restriction applies generally to the order flow received by the member from all non-member broker-dealers.
- 4 See Rule 3370(b)(4)(B)(i).
- 5 See Rule 3370(b)(4)(B)(ii).

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