

Notice to Members

JANUARY 2004

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Operations

KEY TOPICS

NASD Rule 3370
Short Sale Orders

INFORMATIONAL

Amendments to NASD Rule 3370, Affirmative Determination Requirements

SEC Approves NASD Rule Proposal Requiring Members to Make Affirmative Determinations for Short Sale Orders Received from Non-Member Broker/Dealers; **Effective Date: February 20, 2004**

Executive Summary

The Securities and Exchange Commission (SEC) approved amendments to Rule 3370 (Prompt Receipt and Delivery of Securities—the “Affirmative Determination” Rule) that expand the scope of the affirmative determination requirement to include orders received from non-member broker/dealers.¹ As revised, Rule 3370 applies to orders received by member firms from both customers and non-member broker/dealers, as well as most firm proprietary orders. The revisions also add an exception for “proprietary” short sales of non-member broker/dealers provided the member can establish that the order meets certain conditions.

The text of the amendments as provided in Attachment A become effective on February 20, 2004.

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy & Oversight, at (202) 728-8104.

04-03

Discussion

NASD Rule 3370 requires, among other things, that no member or person associated with a member shall effect a "short" sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer by settlement date. Because NASD's definition of "customer" excludes a "broker" or "dealer," the affirmative determination requirements did not apply to orders from "non-member broker/dealers."² The failure to subject short sales by such persons to the affirmative determination requirement affects the integrity of the marketplace by increasing the possibility of failures to deliver and also creates regulatory disparity by allowing certain firms to effect short sales outside the purview of NASD's affirmative determination requirements. To address these concerns, NASD has amended Rule 3370 to apply to short sale orders for any customer or "non-member broker/dealer."

The amendments also provide an exemption for certain proprietary orders of non-member broker/dealers. Specifically, Rule 3370(b)(2)(B) provides exemptions for, among others, proprietary orders of member firms that are bona fide market making transactions, or transactions that result in bona fide fully hedged or arbitrated positions. Proprietary orders of a non-member broker/dealer likewise are exempt from the affirmative determination requirements if they meet the same conditions for the exemptions applicable to proprietary orders of member firms, and the following two conditions are satisfied: (1) the non-member broker/dealer must be registered with the SEC; and (2) if using the market maker exemption, the non-member broker/dealer is registered or qualified as a market maker in the securities and is selling such securities in connection with bona fide market making.

Endnotes

- 1 File No. SR-NASD-2001-85 (Nov. 27, 2001), SEC Release No. 34-48788 (Nov. 14, 2003), 68 *Fed. Reg.* 65978 (Nov. 24, 2003).
- 2 While NASD member broker/dealers are excluded from the definition of "customer" under NASD Rule 0120(g), such firms have an independent obligation to comply with NASD's Affirmative Determination Rule.

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ATTACHMENT A

New text is underlined; deletions are in brackets.

3370. Prompt Receipt and Delivery of Securities

(a) No Change

(b) Sales

(1) No Change.

(2) "Short Sales"

(A) Customer and non-member broker/dealer short sales

No member or person associated with a member shall accept a "short" sale order for any customer or non-member broker/dealer in any security unless the member or person associated with a member makes an affirmative determination that the member 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. This requirement shall not apply, however, to transactions in corporate debt securities or transactions in security futures, as defined in Section 3(a)(55) of the Act, or proprietary orders of a non-member broker/dealer that meet one of the exceptions in subparagraph (B) below, provided, however, that (i) the non-member broker/dealer is registered with the Securities and Exchange Commission, and (ii) if using the market maker exception, the non-member broker/dealer is registered or qualified as a market maker in the securities and is selling such securities in connection with bona fide market making.

(B) No Change

(3) No change

(4) “Affirmative Determinations”

(A) No change

(B) To satisfy the requirement for an “affirmative determination” contained in paragraph (b)(2) above for customer, non-member broker/dealer, and proprietary short sales, the member or person associated with a member must keep a written record [which] that includes:

(i) if a customer or non-member broker/dealer assures delivery, the present location of the securities in question, whether they are in good deliverable form and the customer’s or non-member broker/dealer’s ability to deliver them to the member within three (3) business days; or

(ii) No change