**INFORMATIONAL**

# Short Sales

## NASD Regulation Reiterates That Members Must Comply With All Short Sale Rules When Receiving Orders Through Electronic Order Systems Or The Internet And Reiterates The Operation Of The Affirmative Determination Rule

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Individual Investor
- Internal Audit
- Legal & Compliance
- Operations
- Senior Management
- Technology
- Trading & Market Making

**KEY TOPICS**

- Affirmative Determination
- Internet Trading
- NASD Conduct Rules 3350 and 3370
- Short Sales


### Executive Summary

The purpose of this *Notice* is to reiterate the long-standing position of NASD Regulation, Inc. (NASD Regulation℠) and Nasdaq® that member firms must comply with the rules concerning short sales regardless of how a short sale order is received, *e.g.*, through the telephone, an electronic transmission, the Internet, or otherwise. Accordingly, firms must comply with the bid test, make affirmative determinations, and identify short sales in the Automated Confirmation Transaction Service℠ (ACT℠) for all proprietary and customer short sale orders that are received electronically through proprietary electronic order routing systems, the Internet, or otherwise.


### Questions/Further Information

Questions concerning National Association of Securities Dealers, Inc. (NASD®) Rule 3350 (Bid Test Rule) should be directed to the Office of General Counsel, The Nasdaq Stock Market, Inc. (The Nasdaq Stock Market®), at (202) 728-8294; or the Legal Section, Market Regulation, NASD Regulation, at (301) 590-6410. Questions concerning NASD Rule 3370 (Affirmative Determination Rule) should be directed to the Office of General Counsel, NASD Regulation, at (202) 728-8071; or the Legal Section, Market Regulation, NASD Regulation, at (301) 590-6410.

### Discussion

Many members receive short sale orders electronically through proprietary electronic order routing systems and through the Internet from customers with online accounts. With this *Notice*, NASD Regulation and Nasdaq reiterate the long-standing position that, absent an exemption, firms must comply with the short sale rules when effecting customer short sale orders, regardless of whether the order is received by telephone or electronically through a proprietary electronic order routing system, the Internet, or otherwise. Failure to do so will result in a violation of the short sale rules and possible disciplinary action.

As a result of the significant increase in online trading, member firms and customers have sought guidance from the NASD concerning the application of the short sale rules to certain specific situations referred to as “double selling,” “over selling,” and “mistaken sale not long.” (Hereinafter collectively referred to as “inadvertent short sales.”) Specifically, these situations include, among others:

(1) a customer placing an online sell order to sell a long position in his/her account and, when the order is not immediately executed, entering a second sell order for the same shares resulting in the execution of both orders;

(2) a customer canceling a limit order to sell and replacing it with a market order before confirmation of cancellation of the first order, with both orders eventually being executed because of delays in processing the order cancellation; or

(3) a customer accidentally entering two sell orders for the same shares or entering a sell order for shares when he/she intended to enter buy orders.

All of these scenarios result in the customer causing the member to effect a short sale for the customer even though the customer apparently did not intend to sell short.

Notwithstanding the fact that the customer may not intend to sell short, a member that offers online trading services to its customers must program such systems to ensure that the member is complying with all trading and market-making rules, including the short sale rules. In other words, when the above referenced situations occur, members' systems should consider the stock positions in customer accounts and the number and status of all orders and cancellation instructions. Member firm automated systems should execute such short sales in compliance with the short sale rules, and NASDR℠ and Nasdaq recommend that firms design their systems to provide customers with notice when they may have placed an "inadvertent" short sale. In sum, the means of receipt of a short sale and the "inadvertent" nature of a short sale in no way eliminate or reduce the obligations of member firms to comply with the short sale rules.

### Application Of Short Sale Rules To Orders Placed Over The Internet

The Bid Test Rule provides that, absent an exemption, no member shall effect a short sale for the account of a customer or for its own account in a Nasdaq National Market® security at or below the current best (inside) bid when the current best (inside) bid as displayed by The Nasdaq Stock Market is below the preceding best (inside) bid in the security. When a customer short sale order is received electronically or through the Internet, the member must effect such orders in compliance with the Bid Test Rule. Moreover, firms must effect short sales in compliance with the Bid Test Rule regardless of whether the short sale is an "inadvertent" short sale from the customer's perspective.[1]

Similarly, pursuant to NASD Rule 6130(d)(6), a transaction report entered into ACT that reports the execution of such an order must include a symbol that identifies the transaction as a short sale. As stated above, firms must comply with this rule regardless of the manner in which customer short sales are received and whether the short sales are inadvertent from the customer's perspective.

NASD Conduct Rule 3370 regulates both customer and proprietary short sales. As to customer short sales, NASD Conduct Rule 3370(b)(2)(A) states, in relevant part, that "[n]o member or person associated with a member shall accept 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 for delivery by settlement date." Under this provision, the affirmative determination is a prerequisite for accepting a customer's short sale order. Thus, firms must make the required affirmative determination before the customer's short sale order can be accepted and executed. A member firm must conduct the requisite affirmative determination regardless of whether the order is received electronically or through the Internet or whether the order was placed "inadvertently" by the customer.[2]

NASDR also notes that the obligation for making an affirmative determination and complying with the Bid Test Rule rests with member firms and may not be shifted to customers. For instance, members may not satisfy the Affirmative Determination Rule for short sales by merely giving warnings to customers that they are required to make good delivery of the securities or that they will be financially responsible for any losses incurred from covering short sales.

### NASD Regulation Reiterates Operation Of The Affirmative Determination Rule

NASD Regulation also reiterates that, absent an exemption, an affirmative determination must be made before executing a proprietary short sale for each and every short sale. A member can **not** implement procedures whereby it only conducts an affirmative determination for proprietary short sales if the firm maintains a short position overnight (that is, if the firm is flat in a certain security by the end of the trading day it will not conduct an affirmative determination). Such a procedure conflicts with the Rule's requirement that a firm make an affirmative determination before executing a proprietary short sale and would circumvent the objectives of the Affirmative Determination Rule that are designed to help prevent situations where there is a shortage of deliverable stock or a failure to deliver. Accordingly, firms are required to ensure that securities are available to cover a proprietary short position before executing the short sale. To make an affirmative determination only if a short position will be maintained overnight would be a direct violation of the Affirmative Determination Rule.[3]

## Endnotes

[1]NASDR and Nasdaq also reiterate that firms must effect short rules in exchange-listed securities received electronically, via the Internet, or otherwise in compliance with the Securities Exchange Act Rule 10a-1.

[2]NASD Rule 3370(b)(4) provides that there is no mandated method by which firms must comply with the affirmative determination rule. Accordingly, members may design automated systems that obtain and record the information required by Rule 3370 for short sales. Alternatively, members may direct customers who attempt to place short sale orders electronically or through the Internet to speak with a registered representative by telephone in order to make the affirmative determination.

[3]Likewise, firms may not wait until the end of the day to determine whether an affirmative determination is required for customer short sales. Firms are required to receive assurances that securities are available to cover a customer's potential short position before effecting the customer's short sale order.