NASD Notice to Members 99-28

NASD Reminds Members Of Obligations Relating To The Short-Sale Rule

Suggested Routing

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Executive Summary

This *Notice to Members* supersedes *Notice to Members 98-65*, restates the views of NASD Regulation, Inc. (NASD Regulation℠) and The Nasdaq Stock Market® (Nasdaq®) concerning National Association of Securities Dealers, Inc. (NASD®) Rule 3350 (Short-Sale Rule) that were discussed in *Notice to Members 98-65*, and corrects a statement concerning the use of cross-guaranteed accounts for Regulation T purposes.

In 1994, the Short-Sale Rule was adopted to stop market-destabilizing speculative short sales in Nasdaq National Market® (NNM) securities. To prevent this conduct, the Short-Sale Rule prohibits member firms from executing customer short sales and non-Market Maker proprietary short sales in an NNM security at or below the current inside bid when the current inside bid is lower than the previous inside bid.

It has come to the attention of NASD Regulation and Nasdaq that certain NASD members may be assisting customers in the circumvention of this Rule. Specifically, these members are failing to net security positions of accounts for customers who maintain accounts in their name and exercise control over, or operate in concert with, other accounts with a strategy designed to circumvent the Short-Sale Rule. The failure to net these positions has permitted these customers, who operate the two accounts with a single investment strategy, to avoid application of the Short-Sale Rule. Members are expected to establish and maintain supervisory procedures to detect and deter this improper trading activity.

The purpose of this *Notice* is to highlight for members that, depending on the facts and circumstances, they may be required to net positions for accounts that are related or under common control to determine whether a sale is long or short and subject to the Short-Sale Rule requirements. NASD Regulation is committed to ensuring strict adherence to the Short-Sale Rule and will carefully review whether firms have engaged in the conduct described in this *Notice* in examinations and investigations. Violations of the Short-Sale Rule will be vigorously pursued.

Questions concerning this *Notice* should be directed to the Office of General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-8294; or the Legal Section, Market Regulation, NASD Regulation, at (301) 590-6410.

Overview

The NASD adopted the Short-Sale Rule to prevent speculative short selling in NNM securities from accelerating a decline in the price of a security and to stop a form of manipulation known as "bear raiding" or "piling on." Bear raiding or piling on occurs when short sellers exert pressure on a stock's price, forcing the price to drop precipitously, frequently within a single trading day. The Short-Sale Rule prohibits member firms from executing customer short sales and non-Market Maker proprietary short sales in an NNM security at or below the current inside bid when the current inside bid is lower than the previous inside bid.[1]

To determine whether a sale is long or short, members must look to the definition of a "short sale" contained in Securities and Exchange Commission (SEC) Rule 3b-3, which is incorporated into the NASD's Short-Sale Rule as Rule 3350(k)(1). Under SEC Rule 3b-3 and NASD Rule 3350, the term "short sale" means any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.

To determine whether the seller is long or short overall, the seller must net all positions in the security. This includes netting positions held in accounts that are under common control or traded with a single investment strategy.

Rule Prohibits Circumvention

The Short-Sale Rule also prohibits a member from knowingly, or with reason to know, effecting sales for the account of a customer or for its own account for the purpose of circumventing the rule.[2] With this *Notice*, NASD Regulation and Nasdaq are clarifying that the following would be a violation of the Short-Sale Rule if a member and its associated persons were found to have assisted customers in the following manner:

- A customer maintains one account (a "long account") that is used to buy and sell various securities several times in a single day. The long account typically begins and ends each day with a long position of 1,000 shares in each security held in that account. The customer also cross guarantees for margin purposes a second account (a "short account"), usually held by a family member or related person.[3] That account holds offsetting short positions of 1,000 shares in the same securities that are held in the long account. In contrast to the long account, the short account generally does not change positions in the securities. At the beginning and end of each day, the combined positions in both accounts for each of the securities are flat. During the trading day, the customer buys and sells securities out of the long account, creating the false appearance of alternating long and flat positions in the securities in the long account. When the two accounts are appropriately combined and treated as one, short sales occur on a regular basis and often result in transactions occurring on down-bids in violation of the NASD's Short-Sale Rule.

NASD Regulation will conduct a facts and circumstances analysis in making a determination as to whether customer accounts should be netted for purpose of compliance with the Short-Sale Rule. When conducting such analysis, NASD Regulation will, among other things, consider:

(1) whether a single person exercises discretion over both accounts;

(2) whether the accounts are cross guaranteed for margin purposes;

(3) whether the accounts belong to a family member or related person or were opened contemporaneously (*e.g.*, on the same day); or

(4) whether a similar pattern is occurring in other customer accounts at a firm. This analysis will consider all the facts and circumstances concerning the establishment, maintenance, and trading of these accounts.

The presence or absence of any single factor reflected above does not necessarily lead to the conclusion that such accounts should, or should not, be netted.

NASD Regulation will closely watch for the above-described conduct and for similar schemes that attempt to circumvent application of the Rule.

Members must take steps to develop compliance procedures to guard against such abusive trading practices. Members should also instruct their associated persons not to accept orders for execution where customers are operating two or more accounts in order to circumvent the Rule. A finding of such abuses may result in the imposition of NASD disciplinary action against the member and its associated persons and a referral of such trading conduct by persons outside the jurisdiction of the NASD to other appropriate regulatory authorities.

Endnotes

[1] NASD Rule 3350(a).

[2] NASD Rule 3350(e).

[3] Cross-guaranteed accounts refer to an agreement where one account is guaranteed by another account to enable their consolidation for the purpose of allowing the margin that must be maintained in those accounts to be determined on the net positions of both accounts. Such a guarantee must be in writing and permit the member carrying the account to use the money and securities in the guaranteeing account to carry the guaranteed account or to pay any deficit therein. *See* NASD Rule 2520(f)(4) and *Notice to Members 98-102* (December 1998). *Notice to Members 98-65* may have led members to believe that margin accounts may be cross guaranteed to satisfy Regulation T requirements. This is an incorrect statement. Regulation T provides, in pertinent part, "*Guarantee of accounts*. No guarantee of a customer's account shall be given any effect for purposes of this part." Reg. T, Section 220.3(d).