

Notice to Members

JULY 2004

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Senior Management
Trading

KEY TOPICS

Affirmative Determination
Rule 3370(b)(2)(B)
Rule 3370(b)(5)(B)
Short Sales

GUIDANCE

Short Sales

Guidance on the Requirements for Availability
of the Bona Fide Fully Arbitrated Exemption

Executive Summary

There has been discussion in the financial press about the listing of securities on foreign markets without a company's knowledge or authorization. Some reports have suggested that the purpose behind such listings is to avoid the requirements of Rule 3370 (affirmative determination requirements) through the use of the arbitrage exemption available under subparagraphs (b)(2)(B) and (b)(5)(B) of Rule 3370. Without commenting on listing activity occurring in non-U.S. markets, NASD is taking this opportunity to remind member firms of their affirmative determination obligations for both member and non-member proprietary short sale transactions and under what circumstances the bona fide fully arbitrated exemption is available.

Questions/Further Information

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

Discussion

NASD Rule 3370(b)(2)(B) requires that, prior to effecting a short sale order for its own account (proprietary short sale), a member (or associated person) must make an affirmative determination that the member can borrow the security or otherwise provide for delivery by the settlement date. The affirmative determination requirements also apply to orders from non-member broker-dealers other than those orders executed by a member as an arm's length transaction.¹ In addition, where orders are executed by a non-member broker-dealer on or through electronic communications networks (ECNs) or alternative trading systems (ATSs), a member that operates the ECN or ATS is responsible for ensuring compliance with the affirmative determination requirements with respect to such orders.

NASD Rule 3370(b)(2)(B) provides an exemption for, among others, proprietary orders of member firms that result in bona fide, fully arbitrated positions. Accordingly, proprietary orders of a member firm are exempt from the affirmative determination requirements if they meet the conditions for the bona fide fully arbitrated exemption. Likewise, proprietary orders of a non-member broker-dealer that is registered with the Securities and Exchange Commission (SEC) are also exempt from the affirmative determination requirements if the member that receives the order is able to verify and document that the non-member order meets the conditions for the bona fide fully arbitrated exemption applicable to proprietary orders of member firms. It is important to note, however, that the uniform locate requirements that are part of Regulation SHO, which become effective January 3, 2005, will not provide for a similar exemption for short sales that are part of arbitrage transactions.

NASD Rule 3370(b)(5)(B) provides guidelines in determining the availability of the bona fide fully arbitrated exemption. With respect to arbitrage positions taken when the same security trades on two markets, the guidelines provide that a short sale transaction would be exempt from the affirmative determination requirements if a long position is taken in a security purchased in one market, together with an offsetting short sale of the same security in a different market, at as nearly the same time as practicable for the purpose of taking advantage of a difference in price in the two markets. Members must be in a position to demonstrate that they are in fact hedged at the time of the short sale and have executed such transactions in a manner consistent with the purpose of the exemption before applying such exemption to the locate requirements of Rule 3370.

The bona fide fully arbitrated exemption was established to recognize those short-selling transactions engaged in for risk reduction and market liquidity. Bona fide arbitrage exists where essentially contemporaneous short sales and purchases are effected to capture the spread resulting from a current differential in pricing. To claim the bona fide fully arbitrage exemption, there must be an offsetting transaction that occurs at as nearly the same time as practicable. The mere speculative listing of prices or offers to deal on another market would not constitute bona fide arbitrage; rather, an actual offsetting arbitrage transaction must be effected on another market at as nearly the same time as practicable for the purpose of taking advantage of a difference in price in the two markets. Accordingly, uncovered short positions that are not hedged at a time that is virtually identical to the time of the execution of the short sale are not entitled to the exemption. Any time difference should only be the time necessary to execute the transaction in two different markets.

NASD also reminds members that intend to rely on the bona fide fully arbitrated exemption that they will be required to demonstrate, upon request, how every applicable short sale transaction meets the bona fide fully arbitrated exemption. Members must be able to establish and document that a proprietary order, whether a member proprietary order or a non-member broker-dealer proprietary order, satisfies the terms of the exemption. As with all exemptions to the affirmative determination requirements, NASD reminds members that the bona fide fully arbitrated exemption is narrowly applied and may only be used for legitimate arbitrage purposes and may not be used in an effort to circumvent the requirements of Rule 3370, facilitate speculative short selling, or otherwise engage in manipulative behavior. Members also are reminded that, as with the bona fide market making exemption, proprietary positions taken to facilitate a short sale or short sale equivalent position for a customer will not be deemed to fall within the bona fide fully arbitrated exemption.

Endnotes

1. See *Notice to Members 04-21* (March 17, 2004).