Notice to Members

APRIL 2006

SUGGESTED ROUTING

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KEY TOPICS

Close-Out Requirements
SEC Regulation SHO
SEC Rule 203(b)(3)
Short Sales

GUIDANCE

Short Sales

SEC Division of Market Regulation Issues Interpretive Guidance Regarding Regulation SHO Close-Out Requirements; **Effective Date: May 1, 2006**

Executive Summary

NASD is issuing this *Notice* to highlight recent guidance published by the Securities and Exchange Commission (SEC) relating to the "close-out" requirements under Regulation SHO. Regulation SHO, among other things, imposes uniform delivery requirements on broker-dealers for certain securities that have a substantial level of failures to deliver at a registered clearing agency, referred to as "threshold securities." Regulation SHO requires broker-dealers that are participants of a registered clearing agency (clearing agency participants) to take action to "close-out" failure-to-deliver positions in threshold securities that have persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity.

On March 17, 2006, the SEC Division of Market Regulation published Question and Answer (Q&A) 5.8 providing interpretive guidance relating to the method by which clearing agency participants may apply any reductions to their end-of-day fail-to-deliver positions at the National Securities Clearing Corporation (NSCC) that occur during the applicable 13 consecutive settlement day period. Specifically, the SEC stated that clearing agency participants that choose to apply reductions to their close-out requirements prior to the 13th consecutive settlement day must first apply any reduction to the most recent increase in its fail to deliver position reflected at NSCC. NASD expects that all members will fully implement the methodology set forth in Q&A 5.8 by May 1, 2006.

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

As further detailed in *Notices to Members 04-93* (December 2004) and *05-33* (April 2005), on June 23, 2004, the SEC adopted certain provisions of a new short sale regulation, designated Regulation SHO.[1] Regulation SHO includes several new provisions relating to short sales, one of which imposes delivery requirements on broker-dealers for certain securities that have a substantial level of failures to deliver at a registered clearing agency, referred to as "threshold securities." Specifically, Rule 203(b)(3) of Regulation SHO requires broker-dealers that are participants of a registered clearing agency to take action to "close-out" failure-to-deliver positions in threshold securities that have persisted for 13 consecutive settlement days by purchasing securities of like kind and quantity. If the fail-to-deliver position is not closed out in the requisite time period, the broker-dealer and any broker-dealer for which it clears transactions are prohibited from effecting further short sales in that threshold security without borrowing or entering into a bona fide agreement to borrow the security.

On March 17, 2006, the staff of the SEC Division of Market Regulation published on its Web site interpretive guidance regarding the close-out requirements under Regulation SHO. Specifically, Q&A 5.8 provides guidance on the method by which clearing agency participants may apply any reductions in their end-of-day fail-to-deliver positions at NSCC that occur during the applicable 13 consecutive settlement day period for purposes of compliance with the Regulation SHO close-out requirements.[2] In this interpretive guidance, the SEC provides that, if prior to the 13th consecutive settlement day, the participant chooses to reduce its open fail-to-deliver position and such reduction is reflected in the participant's end-of-day net fail-to-deliver position at NSCC, the participant must first apply the reduction to the most recent increase in its fail-to-deliver position reflected at NSCC and then to any increase in its fails position that existed at NSCC on the day preceding that day and so forth until the entire amount of the reduction has been applied. The SEC guidance also provides specific examples to illustrate how to apply such reductions in accordance with the required methodology.

A copy of the interpretive guidance is available on the SEC's Web site at *www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm*. NASD encourages members and other interested parties to review the interpretive guidance, as NASD expects that all members will fully implement the methodology set forth in Q&A 5.8 by May 1, 2006.

Endnote

1 *See* Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

2 *See* Division of Market Regulation: Responses to Frequently asked Questions Concerning Regulation SHO, Question and Answer 5.8 (March 17, 2006).