

Notice to Members

JUNE 2006

SUGGESTED ROUTING

Internal Audit
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KEY TOPICS

Short Sales
Rule 3210

GUIDANCE

Short Sale Delivery Requirements

SEC Approves New Rule 3210 Applying Short Sale Delivery Requirements to Non-Reporting OTC Equity Securities; **Effective Date: July 3, 2006**

Executive Summary

On April 4, 2006, the Securities and Exchange Commission (SEC) approved new Rule 3210, Short Sale Delivery Requirements, which applies short sale delivery requirements to those equity securities not otherwise covered by the delivery requirements of Regulation SHO, namely non-reporting OTC equity securities.¹ Rule 3210, among other things, requires participants of registered clearing agencies to take action on failures to deliver that exist for 13 consecutive settlement days in certain non-reporting securities. In addition, if the fail to deliver position is not closed out in the requisite time period, a participant of a registered clearing agency or any broker-dealer for which it clears transactions is prohibited from effecting further short sales in the particular specified security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the fail to deliver position is closed out.

Rule 3210, as adopted, is set forth in Attachment A of this *Notice*. Also included in this *Notice* is information about the list of non-reporting securities that meet the requirements of Rule 3210 ("Rule 3210 Threshold Securities List") that NASD will publish. The rule becomes effective on July 3, 2006.

Questions/Further Information

Questions regarding this *Notice* may be directed as follows: for questions regarding Rule 3210, contact the Legal Section, Market Regulation, at (240) 386-5126; or Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071. For questions regarding the Rule 3210 Threshold Securities List, contact NASD Operations at (866) 776-0800.

06-28

Background and Discussion

On June 23, 2004, the SEC adopted Regulation SHO under the Exchange Act, which provides a new regulatory framework governing the short selling of equity securities.² Regulation SHO includes several new provisions relating to short sales, one of which imposes delivery requirements on clearing agency participants for certain securities that have a substantial level of failures to deliver.³ Specifically, Regulation SHO requires clearing agency participants to close out all failures to deliver in a "threshold security" that have existed for 13 consecutive settlement days. Regulation SHO defines a "threshold security" as any equity security of an issuer that is registered under Section 12 of the Exchange Act or that is required to file reports under Section 15(d) of the Exchange Act (referred to as "reporting securities") that (1) for five consecutive settlement days had aggregate fails to deliver at a registered clearing agency of 10,000 shares or more; (2) the level of fails is equal to a least one-half of one percent of the issue's total shares outstanding; and (3) is included on a list published by a self-regulatory organization.

The Regulation SHO delivery requirements apply only to reporting securities. NASD believes applying delivery requirements to non-reporting securities is an important step in reducing long-term fails to deliver in this sector of the marketplace. Therefore, NASD proposed, and the SEC approved, new Rule 3210, which applies a delivery framework to non-reporting OTC equity securities substantially similar to the Regulation SHO delivery framework. Rule 3210 requires clearing agency participants to close out all failures to deliver in "non-reporting threshold securities" that have existed for 13 consecutive settlement days. For purposes of Rule 3210, a non-reporting threshold security is any equity security that is not a reporting security and, for five consecutive settlement days, has: (1) aggregate fails to deliver at a registered clearing agency of 10,000 shares or more; and (2) a reported last sale during normal market hours (9:30 a.m. to 4 p.m., Eastern Time (ET)) for the security on that settlement day that would value the aggregate fail to deliver position at \$50,000 or more.⁴

If the fail to deliver position is not closed out in the requisite time period, a clearing agency participant or any broker-dealer for which it clears transactions would be prohibited from effecting further short sales in the particular specified security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the fail to deliver position is closed out. To the extent that the participant can identify the broker-dealer(s) that have contributed to the fail to deliver position, the requirement to borrow or arrange to borrow prior to effecting further short sales may apply only to those particular broker-dealers to which the participant has allocated such fail to deliver position.

NASD will publish daily a list of the non-reporting securities that meet the threshold requirements of Rule 3210 (Rule 3210 Threshold Securities List). To be removed from the Rule 3210 Threshold Securities List, a security must not meet either of the threshold tests in Rule 3210 for five consecutive settlement days.

NASD intends to apply and interpret the requirements of Rule 3210 consistent with the SEC's application and interpretation of Regulation SHO. In this regard, the SEC Division of Market Regulation published Responses to Frequently Asked Questions Concerning Regulation SHO, in which the SEC staff addresses, among other things, questions relating to the Regulation SHO delivery requirements, close-out requirements and pre-borrow requirements. 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.

Rule 3210 becomes effective July 3, 2006. Consistent with the application and interpretation of Regulation SHO, open fail positions in non-reporting securities that exist prior to July 3, 2006 will not be required to be closed out under Rule 3210.⁵ As such, on July 3, 2006, NASD will begin the calculations necessary to determine whether securities qualify as non-reporting threshold securities, and July 11, 2006 is the first day for which NASD will publish a non-reporting threshold list. Until a security appears on a non-reporting threshold list for 13 consecutive settlement days and an open fail position for such security exists for that same period, Rule 3210 does not require a broker-dealer to close out the open fail position. Therefore, the first day on which a close-out action would be required under Rule 3210 is July 28, 2006.

Questions and Answers Relating to New Rule 3210

To help members implement Rule 3210, NASD is publishing the following questions and answers relating to the Rule 3210 Threshold Securities List.

Q1 What is a non-reporting threshold security?

A1 As defined in Rule 3210, a "non-reporting threshold security" is any equity security of any issuer that is not registered under Section 12 of the Exchange Act, and for which the issuer is not required to file reports under Section 15(d) of the Exchange Act, where, (1) for five consecutive settlement days:

- ♦ There are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more; and
- ♦ The reported last sale during normal market hours (9:30 a.m. to 4 p.m., Eastern Time (ET)) for the security on that settlement day would value the aggregate fail to deliver position at \$50,000 or more; and

(2) The security is included on a list published by NASD.

A security ceases to be a non-reporting threshold security if it does not meet either of the threshold tests in (1) above for five consecutive settlement days.

Q2 How can I access the Rule 3210 Threshold Securities List?

A2 NASD will calculate the Rule 3210 Threshold Securities List on a daily basis. The Rule 3210 Threshold Securities List will be combined with the Regulation SHO Threshold Security List currently posted on www.nasdaqtrader.com/asp/regsho.aspx. The combined list will contain a separate column indicating that the security is subject to Rule 3210.

Q3 What will be the format of the file?

A3 The file layout and data field definitions are the same as the Regulation SHO file layout and data fields, found at: www.nasdaqtrader.com/asp/regsho.aspx.

Q4 What does the date in the file name mean?

A4 The date in the file name reflects the settlement date that the data is based on. For example, the file name for the file posted containing July 11, 2006 settlement date data will be 20060711.

Q5 How can I tell what time the Rule 3210 Threshold Securities List was created?

A5 The end of the data file will contain a file creation timestamp, reflecting the date and time the file is complete. The timestamp will be in the following format: `yyyymmddhhmmss`.

Q6 What if the Rule 3210 Threshold Securities List is posted late?

A6 Consistent with guidance provided by staff of the SEC Division of Market Regulation regarding the Regulation SHO Threshold List, firms will be permitted to use the previous settlement day's Rule 3210 Threshold Securities List to comply with Rule 3210 if the file is unavailable by midnight (00:00 ET). Firms are still obligated to analyze the current settlement day's data when it becomes available to determine compliance with Rule 3210's close-out requirements.

Q7 When will the Rule 3210 Threshold Securities List be posted?

A7 As noted above, Rule 3210 defines a "non-reporting threshold security" as one that exceeds the specified level of fails for five consecutive settlement days. Since the new rule takes effect on July 3, 2006, the first date a security can meet this definition will be five settlement days after the effective date. Accordingly, the first Rule 3210 Threshold Securities List will be posted before midnight on July 10, 2006, and will be available before the opening of trading on July 11, 2006.

Endnotes

- 1 See Securities Exchange Act Release No. 53596 (April 4, 2006), 71 FR 18392 (April 11, 2006) (File No. SR-NASD-2004-044).
- 2 See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).
- 3 The term "clearing agency participants" refers to "participants" (as defined in Section 3(a)(24) of the Exchange Act) of a "registered clearing agency," meaning a clearing agency (as defined in Section 3(a)(23)(A) of the Exchange Act) that is registered with the SEC pursuant to Section 17A of the Exchange Act.
- 4 In the event there is no reported last sale on any settlement day during such five-day period, the value of the aggregate fail position would be based on the previously reported last sale.
- 5 See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO (Question 5.1). As noted in Question 5.1, this does not affect the obligations of sellers of securities to deliver those securities to buyers under existing delivery and settlement guidelines.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

3210. [Reserved.] Short Sale Delivery Requirements

(a) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a non-reporting threshold security for 13 consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity.

(b) The provisions of this rule shall not apply to the amount of the fail to deliver position that the participant of a registered clearing agency had at a registered clearing agency on the settlement day immediately preceding the day that the security became a non-reporting threshold security; provided, however, that if the fail to deliver position at the clearing agency is subsequently reduced below the fail to deliver position on the settlement day immediately preceding the day that the security became a non-reporting threshold security, then the fail to deliver position excepted by this paragraph (b)(1) shall be the lesser amount.

(c) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a non-reporting threshold security for 13 consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of SEC Rule 203 of Regulation SHO, may not accept a short sale order in the non-reporting threshold security from another person, or effect a short sale in the non-reporting threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant closes out the fail to deliver position by purchasing securities of like kind and quantity.

(d) If a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this rule relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.

(e) A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this rule where the participant enters into an arrangement with another person to purchase securities as required by this rule, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase.

(f) For the purposes of this rule, the following terms shall have the meanings below:

(1) the term "market maker" has the same meaning as in section 3(a)(38) of the Exchange Act.

(2) the term "non-reporting threshold security" means any equity security of an issuer that is not registered pursuant to section 12 of the Exchange Act and for which the issuer is not required to file reports pursuant to section 15(d) of the Exchange Act:

(A) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more and for which on each settlement day during the five consecutive settlement day period, the reported last sale during normal market hours for the security on that settlement day that would value the aggregate fail to deliver position at \$50,000 or more, provided that if there is no reported last sale on a particular settlement day, then the price used to value the position on such settlement day would be the previously reported last sale; and

(B) is included on a list published by NASD.

A security shall cease to be a non-reporting threshold security if the aggregate fail to deliver position at a registered clearing agency does not meet or exceed either of the threshold tests specified in paragraph (f)(2)(A) of this rule for five consecutive settlement days.

(3) the term "participant" means a participant as defined in section 3(a)(24) of the Exchange Act, that is an NASD member.

(4) the term "registered clearing agency" means a clearing agency, as defined in section 3(a)(23)(A) of the Exchange Act, that is registered with the Commission pursuant to section 17A of the Exchange Act.

(5) the term "settlement day" means any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.

(g) Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may grant an exemption from the provisions of this rule, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons, if such exemption is consistent with the protection of investors and the public interest.