

Notice to Members

SEPTEMBER 2006

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Senior Management
Trading

KEY TOPICS

Bona Fide Market Making
Short Sales
Rule 5100
IM-5100

GUIDANCE

Short Sales

Guidance on the Requirements for Availability of Bona Fide Market Making Activity Exception to NASD Rule 5100

Executive Summary

Rule 5100 generally prohibits a member from effecting short sales in NASDAQ Global Market (NGM) securities¹ otherwise than on an exchange for a customer account, or the member's own account, at or below the current national best (inside) bid, when the current national best (inside) bid is below the preceding national best (inside) bid (the bid test).² Rule 5100(c)(1) provides an exception to the bid test for short sales by a market maker registered in the security in connection with bona fide market making activity. NASD is issuing this *Notice* to remind member firms of the requirements to qualify for the bona fide market making activity exception to NASD's short sale rule contained in Rule 5100.

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

Rule 5100 generally prohibits a member from effecting short sales³ in NGM securities otherwise than on an exchange for a customer account, or the member's own account, at or below the current national best (inside) bid, when the current national best (inside) bid is below the preceding national best (inside) bid. All short sales in NGM securities must comply with Rule 5100 or qualify for an exception to, or exemption from, the rule. Among others, Rule 5100 provides an exception to the bid test for certain bona fide market making activity.

NASD is issuing this *Notice* to remind member firms of the circumstances under which the bona fide market making exception is available. To qualify for the exception, Rule 5100(c)(1) requires that the broker-dealer be a market maker registered in the security and that the short sale activity constitutes bona fide market making activity. The rule also specifically provides that bona fide market making activity does not include transactions unrelated to normal market making activity, such as index arbitrage and risk arbitrage that are independent from a member's market making functions. Although such activity may be part of the firm's overall hedging or risk management strategy, they do not warrant an exception from Rule 5100.

IM-5100(a) provides further guidance as to what constitutes bona fide market making, noting that the bona fide market making exception was established to recognize those short sale transactions engaged in to maintain continuous, liquid markets in NGM securities. IM-5100 further provides that bona fide market making activity would not include activity related to the speculative selling strategies of the member or investment decisions of the firm that is disproportionate to the usual market making patterns or practices of the member in that security.

Market Making Exception to Regulation SHO "Locate" Requirements

The uniform "locate" requirements in Regulation SHO provide a similar exception for short sales effected by a market maker in connection with bona fide market making activities.⁴ Although the Regulation SHO bona fide market making exception applies to the locate requirements, NASD believes the standards set forth are equally applicable to the bona fide market making exception to NASD Rule 5100. Accordingly, NASD applies and interprets the bona fide market making exception to Rule 5100 consistent with the SEC's application and interpretation of the exception to the Regulation SHO locate requirements.

In this regard, the SEC staff has indicated that while the determination of whether activity would qualify for the bona fide market making exception will depend on the facts and circumstances of the particular activity, there are clear examples of what types of activities would not be deemed bona fide market making activities.⁵ Specifically, in its Regulation SHO Adopting Release, the SEC indicated that bona fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.⁶ Likewise, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona fide market making for purposes of the exception.⁷ Moreover, a market maker that continually executes short sales away from its posted quotes would generally not be able to rely on the bona fide market making exception.⁸

Further, the SEC stated that bona fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with the locate requirement by the other broker-dealer or customer.⁹ For example, to the extent that a member engages in short selling activity under the pretext of market maker status to establish short positions at the direction of customers who would otherwise not be able to comply with the locate requirements, such activity would not constitute bona fide market making activity and, thus, not be exempt from the locate requirements of Regulation SHO.¹⁰ Accordingly, members are reminded that short sale positions taken to facilitate a short sale position of a customer that do not comply with Regulation SHO generally will not be deemed to fall within the bona fide market making exception.

Surveillance and Examination of the Rule 5100 Requirements

NASD closely monitors member activity for violations of Rule 5100, including use of the market making exception and schemes that attempt to avoid application of the rule. Rule 3010 requires members to establish and maintain a supervisory system that is designed to ensure compliance with NASD rules and federal securities laws. Members' supervisory systems should include reviews designed to ensure that reliance upon the bona fide market making exception is justified.

Further, NASD is reminding members that intend to rely on the bona fide market making exception to Rule 5100 that they will be expected to be able to demonstrate, upon request, how the short sale transaction meets the bona fide market making exception. Thus, members availing themselves of this exception must have a reasonable basis to believe that each short sale transaction satisfies the terms of the exception and must be able to provide documentation in support of such position.

Endnotes

- 1 Note: NASDAQ National Market securities were renamed NASDAQ Global Market securities. See Securities Exchange Act Release No. 54071 (June 29, 2006), 71 FR 38922 (July 10, 2006) (File No. SR-NASD-2006-068).
- 2 On June 30, 2006, the SEC approved SR-NASD-2005-087, which amends certain NASD rules to reflect the separation of NASDAQ from NASD upon the operation of the NASDAQ Exchange as a national securities exchange. See Securities Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006). Among other amendments, NASD's rule change amended Rule 3350 to renumber it as Rule 5100 and apply it uniformly to short sales of over-the-counter (OTC) transactions reported to the Alternative Display Facility (ADF) or the Trade Reporting Facility (TRF). SR-NASD-2005-087 became effective on August 1, 2006, the date upon which NASDAQ began operation as an exchange for NASDAQ-listed securities.
- 3 The term "short sale" has the meaning contained in Rule 200 of Regulation SHO.

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- 4 Rule 203(b)(1) of Regulation SHO requires that broker-dealers, prior to effecting short sales in all equity securities, locate securities available for borrowing. To comply with the Regulation SHO locate requirements, a broker-dealer must borrow the security, enter into an arrangement to borrow the security or have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. See Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) ("Regulation SHO Adopting Release").
- 5 See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO (Question 4.8). For purposes of Regulation SHO, the term "market maker" is defined in Section 3(a)(38) of the Exchange Act as "any specialist permitted to act as a dealer, any dealer acting in the capacity of a block positioner, and any dealer who, with respect to a security, holds itself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for its own account on a regular or continuous basis." Moreover, the SEC has previously stated that "a bona fide market maker is a broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market." See Securities Exchange Act Release No. 32632 (July 14, 1993), 58 FR 39072, 39074 (July 21, 1993). It is important to note, however, that NASD Rule 5100(c)(1) also requires that the market maker be registered in the security to be eligible for the bona fide market making exception.
- 6 See Regulation SHO Adopting Release at 48015.
- 7 *Id.*
- 8 See Regulation SHO Adopting Release at footnote 68.
- 9 See Regulation SHO Adopting Release at 48015.
- 10 NASD expelled a member firm and barred its principal for creating and maintaining short positions in OTC equity securities on behalf of the firm's clients who were unable to sell the stocks short themselves because they could not satisfy the locate requirements under former NASD Rule 3370. See Department of Market Reg. v. Ryan & Co., LLP, Discip. Proceeding No. CLG050062.

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