

Liability Notification Procedures

SEC Approves Amendments to NASD Rule 11810(i) to Mandate the Use of the Automated Liability Notification System of a Registered Clearing Agency

Effective Date: March 13, 2008

Executive Summary

Effective March 13, 2008, when issuing liability notices in connection with certain securities transactions, firms are required to use the automated liability notification system of a registered clearing agency, provided that both parties to the contract are participants in a registered clearing agency that has such an automated system.¹ NASD Rule 11810(i), as amended, is set forth in Attachment A.

Questions concerning this *Notice* should be directed to Rachael Grad, Counsel, Office of General Counsel, at (202) 728-8290.

Background & Discussion

NASD Rule 11810(i) sets forth the procedures that a party must follow when it is owed securities that have become the subject of a voluntary corporate action, such as a tender or exchange offer. Under Rule 11810(i), the owed party delivers a liability notice to the owing, or failing, counterparty. The liability notice sets a cut-off date for the delivery of the securities by the counterparty, and provides notice to the counterparty that it will be held liable for any damages caused by the failure to deliver the securities in time for the owed party to participate in the voluntary corporate action.

February 2008

Notice Type

- Rule Amendment

Suggested Routing

- Operations
- Legal and Compliance
- Registration
- Senior Management

Key Topic(s)

- Automated Liability Notification System
- Buy-Ins
- Failure-to-Deliver

Referenced Rules & Notices

- NASD Rule 11810(i)

If the owing party delivers the securities in response to the liability notice, it has met its delivery obligation. If the owing party fails to deliver the securities in sufficient time for the owed party to participate in the voluntary corporate action, it will be liable for any damages that may accrue thereby. The onus is on the owed party to communicate its intentions to the owing party and to prove that the owing party received the liability notice.

Prior to the amendments discussed in this *Notice*, Rule 11810(i) required firms to send liability notices via “electronic media having immediate receipt capabilities.” Although there is currently no one acceptable means for sending and tracking liability notices, FINRA understands that it is industry practice to send liability notices via fax to the failing counterparty. Sending liability notices by fax is a manual, paper-intensive process that is subject to error. The financial risk to an owing firm that misses or incorrectly processes a liability notice relating to a voluntary corporate action can be considerable.

In response to industry need for a reliable and uniform method of transmitting liability notices, the Depository Trust Company (DTC) developed the SMART/Track for Corporate Action Liability Notification Service (SMART/Track), a Web-based system for the communication of liability notices that is currently available to all DTC participants. SMART/Track allows DTC participants and NSCC settling firms to create, send, process and track corporate action liability notices. Transmitting liability notices through SMART/Track eliminates paper liability notices and provides firms with an electronic, centralized system that distributes, manages and controls liability notices.

Amended NASD Rule 11810(i) mandates the use of the automated liability notification system when the parties to a contract are both participants in a registered clearing agency that has an automated service for notifying a failing party of the liability that will be attendant to a failure to deliver. When either or both parties to a contract are not participants in a registered clearing agency that has an automated service for issuing liability notices, Rule 11810(i) continues to require the liability notice to be issued using written or comparable electronic media having immediate receipt capabilities.

Endnotes

- 1 See Securities Exchange Act Release No. 56972 (December 14, 2007), 72 FR 73927 (December 28, 2007) (SR-NASD-2007-035) (Order Granting Approval of a Proposed Rule Change Related to Mandated Use of an Automated Liability Notification System).

Attachment A

New language is underlined. Deleted language is bracketed.

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11000. UNIFORM PRACTICE CODE

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11800. CLOSE-OUT PROCEDURES

11810. Buying-In

(a) through (h) No change.

(i) Failure to Deliver and Liability Notice Procedures

(1) (A) If a contract is for warrants, rights, convertible securities or other securities which (i) have been called for redemption; (ii) are due to expire by their terms; (iii) are the subject of a tender or exchange offer; or (iv) are subject to other expiring events such as a record date for the underlying security and the last day on which the securities must be delivered or surrendered (the expiration date) is the settlement date of the contract or later the receiving member may deliver a Liability Notice to the delivering member as an alternative to the close-out procedures set forth in paragraphs (a) through (g). When the parties to a contract are both participants in a registered clearing agency that has an automated service for notifying a failing party of the liability that will be attendant to a failure to deliver, the transmission of the liability notice must be accomplished through the use of said automated notification service. When the parties to a contract are not both participants in a registered clearing agency that has an automated service for notifying a failing party of the liability that will be attendant to a failure to deliver, [S]such [N]notice must be issued using written or comparable electronic media having immediate receipt capabilities no later than one business day prior to the latest time and the date of the offer or other event in order to obtain the protection provided by this Rule.

(B) If the contract is for a deliverable instrument with an exercise provision and the exercise may be accomplished on a daily basis, and the settlement date of the contract to purchase the instrument is on or before the requested exercise date, the receiving member may deliver a Liability Notice to the delivering member no later than 11:00 a.m. on the day the exercise is to be effected. Notice may be redelivered immediately to another member but no later than noon on the same day. When the parties to a contract are both participants in a registered clearing agency that has an automated service for notifying a failing party of the liability that will be attendant to a failure to deliver, the transmission of the liability notice must be accomplished through use of said automated notification service. When the parties to a contract are not both participants in a registered clearing agency that has an automated service for notifying a failing party of the liability that will be attendant to a failure to deliver, [S]such [N]notice must be issued using written or comparable electronic media having immediate receipt capabilities. If the contract remains undelivered at expiration, and has not been canceled by mutual consent, the receiving member shall notify the defaulting member of the exact amount of the liability on the next business day.

(C) No change.

(2) through (4) No change.

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