

November 26, 2001

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2001-85**
Amendments to NASD Rule 3370, Affirmative Determination Requirements

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Gary L. Goldsholle, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8104; e-mail gary.goldsholle@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Patrice M. Gliniecki
Vice President and
Deputy General Counsel

Enclosures

File No. SR-NASD-2001-85
Consists of 15 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”), the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend NASD Rule 3370(b)(2)(A) and the corresponding recordkeeping requirements under Rule 3370(b)(4)(B) (the “Affirmative Determination Requirements”) to require that, prior to accepting a short sale order from a broker/dealer that is not an NASD member (“non-member broker/dealer”), a member must make an affirmative determination that the member will receive delivery of the security from the non-member broker/dealer or that the member can borrow the security on behalf of the non-member broker/dealer for delivery by the settlement date.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * *

Rule 3370. Prompt Receipt and Delivery of Securities

* * *

(b)(2) “Short Sales”

(A) Customer and non-member broker/dealer short sales

No member or person associated with a member shall accept a “short” sale order for any customer or non-member broker/dealer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or non-

member broker/dealer or that the member can borrow the security on behalf of the customer or non-member broker/dealer for delivery by settlement date. This requirement shall not apply, however, to transactions in corporate debt securities, and proprietary orders of a non-member broker/dealer that meet one of the exceptions in subparagraph (B) below.

* * *

(3) No change

(4) “Affirmative Determinations”

(A) No change

(B) To satisfy the requirement for an "affirmative determination" contained in paragraph (b)(2) above for customer, non-member broker/dealer, and proprietary short sales, the member or person associated with a member must keep a written record [which] that includes:

(i) if a customer or non-member broker/dealer assures delivery, the present location of the securities in question, whether they are in good deliverable form and the customer's or non-member broker/dealer's ability to deliver them to the member within three (3) business days; or

(ii) No change

* * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on October 24, 2001, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries (“Delegation Plan”). The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on October 25, 2001. No other action by NASD Regulation is necessary for the filing of the proposed rule change. Section 1 of Article IV of the NASD By-Laws and Section II.A.1. of the Delegation Plan permit the Board of Governors of NASD Regulation to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective date of the proposed rule change in a *Notice to Members* to be published no later than 60 days following Commission approval. The effective date will be approximately 30 days following publication of the *Notice to Members* announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Gary Goldsholle, Associate General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8104.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Rule 3370(b)(2)(A) currently provides that no member or person associated with a member shall accept a short sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will

receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. For purposes of Rule 3370(b)(2), the term “customer” is defined in NASD Rule 0120(g) and excludes a broker or dealer.¹

As a result, the requirements of Rule 3370(b)(2)(A) generally would not apply directly to orders received by a member from another broker/dealer (the “originating broker/dealer”). This does not present regulatory concerns where the originating broker/dealer is also an NASD member, because, as a member, the originating broker/dealer would have an independent obligation to comply with the Affirmative Determination Requirements with respect to the order. Non-member broker/dealers, however, are not subject to NASD rules and, therefore, are not independently required to comply with the NASD’s Affirmative Determination Requirements. Thus, under current rules, the Affirmative Determination Requirements generally do not apply to short sale orders originating with a non-member broker/dealer and subsequently routed to an NASD member.

NASD Regulation believes that the failure to have uniform application of the Affirmative Determination Requirements affects the integrity of the marketplace by possibly resulting in increased fails to deliver, and also creates regulatory disparity by allowing certain firms to effect short sales outside the purview of the NASD’s Affirmative Determination Requirements.

To address these concerns, the proposed rule change would amend Rule 3370(b)(2)(A) to require that no member or person associated with a member shall accept a short sale order for any customer, or any non-member broker/dealer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or non-member broker/dealer, or that the member can

¹ Rule 0120(g) states that the term “customer” shall not include a broker or dealer.

borrow the security on behalf of the customer or non-member broker/dealer for delivery by settlement date. In such instances, members also would be required to comply with the corresponding recordkeeping requirements under Rule 3370(b)(4)(B).

While NASD members generally are required to make affirmative determinations for both customer and proprietary orders, there are limited exceptions for proprietary orders that are bona fide market making, bona fide fully hedged or bona fide fully arbitrated transactions.² Under the proposed rule change, if a member can establish and document that a proprietary order it has received from a non-member broker/dealer meets one of these exceptions, it would be in compliance with the proposed amendments to the Affirmative Determination Requirements.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that applying Affirmative Determination Requirements to short sale orders of non-member brokers/dealers will ensure the integrity of the marketplace by minimizing possible fails to deliver and eliminate regulatory disparities created when certain short sale orders are not conducted in compliance with the Affirmative Determination Requirements.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

² Rule 3370(b)(2)(B).

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____

Patrice M. Gliniecki
Vice President and Deputy General Counsel

Date: November 26, 2001

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2001-85)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Affirmative Determination Requirements for Short Sale Orders Received by Members from Non-Member Broker/Dealers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend Rule 3370(b)(2)(A) and the corresponding recordkeeping requirements under Rule 3370(b)(4)(B) (the “Affirmative Determination Requirements”) of the National Association of Securities Dealers, Inc. (“NASD” or “Association”) to require that, prior to accepting a short sale order from a broker/dealer that is not an NASD member (“non-member broker/dealer”), a member must make an affirmative determination that the member will receive delivery of the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR § 240.19b-4.

security from the non-member broker/dealer or that the member can borrow the security on behalf of the non-member broker/dealer for delivery by settlement date.

Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * *

Rule 3370. Prompt Receipt and Delivery of Securities

* * *

(b)(2) “Short Sales”

(A) Customer and non-member broker/dealer short sales

No member or person associated with a member shall accept a “short” sale order for any customer or non-member broker/dealer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or non-member broker/dealer or that the member can borrow the security on behalf of the customer or non-member broker/dealer for delivery by settlement date. This requirement shall not apply, however, to transactions in corporate debt securities, and proprietary orders of a non-member broker/dealer that meet one of the exceptions in subparagraph (B) below.

* * *

(3) No change

(4) “Affirmative Determinations”

(A) No change

(B) To satisfy the requirement for an "affirmative determination" contained in paragraph (b)(2) above for customer, non-member broker/dealer, and proprietary short sales, the member or person associated with a member must keep a written record [which] that includes:

(i) if a customer or non-member broker/dealer assures delivery, the present location of the securities in question, whether they are in good deliverable form and the customer's or non-member broker/dealer's ability to deliver them to the member within three (3) business days; or

(ii) No change

* * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

Rule 3370(b)(2)(A) currently provides that no member or person associated with a member shall accept a short sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. For purposes of Rule 3370(b)(2), the term “customer” is defined in NASD Rule 0120(g) and excludes a broker or dealer.³

As a result, the requirements of Rule 3370(b)(2)(A) generally would not apply directly to orders received by a member from another broker/dealer (the “originating broker/dealer”). This does not present regulatory concerns where the originating broker/dealer is also an NASD member, because, as a member, the originating broker/dealer would have an independent obligation to comply with the Affirmative Determination Requirements with respect to the order. Non-member broker/dealers, however, are not subject to NASD rules and, therefore, are not independently required to comply with the NASD’s Affirmative Determination Requirements. Thus, under current rules, the Affirmative Determination Requirements generally do not apply to short sale orders originating with a non-member broker/dealer and subsequently routed to an NASD member.

NASD Regulation believes that the failure to have uniform application of the Affirmative Determination Requirements affects the integrity of the marketplace by

³ Rule 0120(g) states that the term “customer” shall not include a broker or dealer.

possibly resulting in increased fails to deliver, and also creates regulatory disparity by allowing certain firms to effect short sales outside the purview of the NASD's Affirmative Determination Requirements.

To address these concerns, the proposed rule change would amend Rule 3370(b)(2)(A) to require that no member or person associated with a member shall accept a short sale order for any customer, or any non-member broker/dealer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or non-member broker/dealer, or that the member can borrow the security on behalf of the customer or non-member broker/dealer for delivery by settlement date. In such instances, members also would be required to comply with the corresponding recordkeeping requirements under Rule 3370(b)(4)(B).

While NASD members generally are required to make affirmative determinations for both customer and proprietary orders, there are limited exceptions for proprietary orders that are bona fide market making, bona fide fully hedged or bona fide fully arbitrated transactions.⁴ Under the proposed rule change, if a member can establish and document that a proprietary order it has received from a non-member broker/dealer meets one of these exceptions, it would be in compliance with the proposed amendments to the Affirmative Determination Requirements.

(2) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices,

⁴ Rule 3370(b)(2)(B).

to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that applying Affirmative Determination Requirements to short sale orders of non-member brokers/dealers will ensure the integrity of the marketplace by minimizing possible fails to deliver and eliminate regulatory disparities created when certain short sale orders are not conducted in compliance with the Affirmative Determination Requirements.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary