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July 18, 2003

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 5th Street, NW
Washington, DC 20549-1001

Re: **File No. SR-NASD-2001-85**
NASD Rule 3370, Affirmative Determination Requirements
Amendment No. 1

Dear Ms. England:

NASD is submitting Amendment No. 1 to the above-referenced rule filing to respond to comments raised by Securities and Exchange Commission ("SEC") staff. The proposed rule change amends Rule 3370 (Affirmative Determination Requirements) to require that prior to accepting a short sale order from a non-member broker/dealer, a member must make an affirmative determination that it will receive delivery of the security from the non-member broker/dealer or that it will be able to borrow the security on behalf of the non-member broker/dealer for delivery by the settlement. The proposed rule change is intended to close a gap in the affirmative determination requirements arising from the fact that NASD's definition of customer excludes a broker or dealer.¹ The SEC published the proposed rule change for comment on January 18, 2002. The SEC received one comment letter from Island ECN, Inc. ("Island") and NASD staff responded to the SEC staff regarding that letter on June 24, 2002. Amendment No. 1 is unrelated to Island's comment letter.

NASD Rule 3370(b)(2) currently provides an exemption for certain proprietary short sales by member broker/dealers. Specifically, the rule excludes (1) bona fide market making transactions by a member in securities in which it is registered as a Nasdaq market maker, (2) bona fide market maker transactions in non-Nasdaq securities in which the market maker publishes a two-sided quotation in an independent quotation medium, and (3) transactions which result in fully hedged or arbitrated positions. In the proposed rule change, NASD sought to establish the same proprietary short sale exemptions for non-member broker/dealers.

¹ See NASD Rule 0120(g).

The SEC staff raised concerns with extending the proprietary short sale exemptions to non-member broker/dealers. The SEC believes that these exemptions, if applied to non-SEC registered broker/dealers, would be difficult to verify, thus potentially undermining the purposes of the proposed rule change. In response to SEC staff comments, NASD staff is proposing to modify the proprietary order exemption as applied to non-member broker/dealers to address this concern. Specifically, NASD staff will condition the use of the proprietary order exemption for non-member broker/dealers on the additional requirements that such non-member broker/dealer: (1) is registered with the SEC, and (2), if using the market maker exemption, is registered, qualified, or otherwise identified as a market maker in the securities and is selling such securities in connection with bona fide market making.

As a result of this change, Rule 3370(b)(2)(A) is amended as follows. [Single underlined text shows the changes proposed in the original rule filing; double underlined text shows the changes proposed in Amendment No. 1. Please note that the rule text also reflects changes to Rule 3370 adopted in SR-NASD-2002-40, which was filed and approved subsequent to the original rule filing.]

(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 or transactions in security futures, as defined in Section 3(a)(55) of the Act, [and]or proprietary orders of a non-member broker/dealer that meet one of the exceptions in subparagraph (B) below, provided, however, that (i) the non-member broker/dealer is registered with the Securities and Exchange Commission, and (ii) if using the market maker exception, the non-member broker/dealer is registered, qualified, or otherwise identified as a market maker in the securities and is selling such securities in connection with bona fide market making.

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We hope the foregoing amendment will enable the SEC staff to approve the proposed rule change. If you have any questions, please do not hesitate to contact me at (202) 728-8104.

Sincerely,

Gary L. Goldsholle