

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50822; File No. SR-NASD-2004-175)

December 8, 2004

Self Regulatory Organizations, Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Repeal of Existing NASD Short Sale Rules in Light of SEC Regulation SHO

Pursuant to Section 19(b)(3) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on November 30, 2004, the National Association of Securities Dealers, Inc. (“NASD”) 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. NASD has designated the proposed rule change as constituting a “non-controversial” rule change under paragraph (f)(6) of Rule 19b-4 under the Act,³ which renders the proposal effective upon receipt of this filing by the Commission. 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 is proposing to repeal NASD Rule 3110(b)(1), Rule 3210, Rule 3370(b) and Rule 11830 in light of the requirements of the SEC’s new short sale regulation, Regulation SHO under the Act. Below is the text of the proposed rule change. Proposed deletions are in brackets.

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3110. Books and Records

¹ 15 U.S.C. 78s(b)(3).

² 17 CFR 240.19b-4.

³ 17 CFR 240.19b-4.

(a) No change

(b) Marking of Customer Order Tickets

[(1) A person associated with a member shall indicate on the memorandum for the sale of any security whether the order is "long" or "short," except that this requirement shall not apply to transactions in debt securities. An order may be marked "long" if (A) the customer's account is long the security involved or (B) the customer owns the security and agrees to deliver the security as soon as possible without undue inconvenience or expense.]

[(2)] A person associated with a member shall indicate on the memorandum for each transaction in a non-Nasdaq security, as that term is defined in the Rule 6700 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market; however, the requirements of this subparagraph shall not apply if two or more priced quotations for the security are displayed in an inter-dealer quotation system, as defined in Rule 2320(g), that permits quotation updates on a real-time basis for which NASD Regulation has access to historical quotation information.

(c) No change.

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3210. Reserved. [Securities "Failed to Receive" and "Failed to Deliver"]

[(a) No member, or person associated with a member, shall sell a security for his own account, or buy a security as a broker for a customer (except exempt securities), if,]

[(1) in respect to domestic securities, he has a fail to deliver in that security 60 days old or older; or]

[(2) in respect to foreign securities, he has a fail to deliver in that security 90 days old or older (except American Depositary Receipt and Canadian securities, which shall be subject to the provisions of subparagraph (1)).]

[(b) Pursuant to the Rule 9600 Series, for good cause shown and in exceptional circumstances, the Association may exempt a member or a person associated with a member from the provisions of this Rule.]

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3370. [Prompt Receipt and Delivery of Securities]Purchases

[(a) Purchases]

No member or person associated with a member may accept a customer's purchase order for any security unless it has first ascertained that the customer placing the order or its agent agrees to receive securities against payment in an amount equal to any execution, even though such an execution may represent the purchase of only a part of a larger order.

[(b) Sales]

[(1) Long Sales]

[No member or persons associated with a member shall accept a long sale order from any customer in any security (except exempt securities other than municipals) unless:]

[(A) The member has possession of the security;]

[(B) The customer is long in his account with the member;]

[(C) The member or person associated with a member makes an affirmative determination that the customer owns the security and will deliver

it in good deliverable form within three (3) business days of the execution of the order; or]

[(D) The security is on deposit in good deliverable form with a member of the Association, a member of a national securities exchange, a broker/dealer registered with the Commission, or any organization subject to state or federal banking regulations and that instructions have been forwarded to that depository to deliver the securities against payment.]

[(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 or transactions in security futures, as defined in Section 3(a)(55) of the Act, 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 or qualified as a market

maker in the securities and is selling such securities in connection with bona fide market making.]

[(B) Proprietary short sales]

[No member shall effect a "short" sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by the settlement date. This requirement will not apply to transactions in corporate debt securities, to transactions in security futures, as defined in Section 3(a)(55) of the Act, to bona fide market making transactions by a member in securities in which it is registered as a Nasdaq or ADF market maker, to bona fide market maker transactions in non-Nasdaq securities in which the market maker publishes a two-sided quotation in an independent quotation medium, or to transactions that result in fully hedged or arbitrated positions.]

[(3) Public Offering]

[In the case of a public offering of securities, paragraph (b)(1) hereof shall not apply during the period from the commencement of the public offering until seven (7) business days following the date of settlement between the underwriter and issuer of the securities; provided, however, that the member believes in good faith that the customer has purchased the securities.]

[(4) "Affirmative Determination"]

[(A) To satisfy the requirements for an "affirmative determination" contained in paragraph (b)(1)(C) above for long sales, the member or person

associated with a member must make a notation on the order ticket at the time the order is taken which reflects the conversation with the customer as to the present location of the securities in question, whether they are in good deliverable form and the customer's ability to deliver them to the member within three (3) business days.]

[(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 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) if the member or person associated with a member locates the stock, the identity of the individual and firm contacted who offered assurance that the shares would be delivered or that were available for borrowing by settlement date and the number of shares needed to cover the short sale.]

[(C) The manner by which a member or person associated with a member annotates compliance with the "affirmative determination" requirement contained in subsection (b)(2) above (e.g., marking the order ticket, recording inquiries in a log, etc.) is not specified by this Rule and,

therefore, shall be decided by each member. Members may rely on "blanket" or standing assurances (i.e., "Easy to Borrow" lists) that securities will be available for borrowing on settlement date to satisfy their affirmative determination requirements under this Rule. For any short sales executed in Nasdaq National Market (NNM) or national securities exchange-listed (listed) securities, members also may rely on "Hard to Borrow" lists indicating NNM or listed securities that are difficult to borrow or unavailable for borrowing on settlement date to satisfy their affirmative determination requirements under this Rule, provided that: (i) any securities restricted pursuant to UPC 11830 must be included on such a list; and (ii) the creator of the list attests in writing on the document or otherwise that any NNM or listed securities not included on the list are easy to borrow or are available for borrowing. Members are permitted to use Easy to Borrow or Hard to Borrow lists provided: (i) the information used to generate the list is less than 24-hours old; and (ii) the member delivers the security on settlement date. Should a member relying on an Easy to Borrow or Hard to Borrow list fail to deliver the security on settlement date, the Association shall deem such conduct inconsistent with the terms of this Rule, absent mitigating circumstances adequately documented by the member.]

[(5) "Bona Fide Fully Hedged" and "Bona Fide Fully Arbitraged"]

[In determining the availability of the exemption provided in paragraph (b)(2)(B) above and in Rule 11830 from short sale requirements for "bona fide fully hedged" and "bona fide fully arbitrated" transactions, the following guidelines shall

apply. These guidelines are for illustrative purposes and are not intended to limit the Association's ability to determine the proper scope of the terms "bona fide fully hedged" or "bona fide fully arbitrated" pursuant to this provision, on a case-by-case basis.]

[(A) Bona Fide Fully Hedged]

[The following transactions shall be considered bona fide fully hedged:]

[(i) Short a security and long a convertible debenture, preferred or other security which has a conversion price at or in the money and is convertible within ninety days into the short security.]

[Example: Long ABCD Company 9% convertible subordinated debentures due 2003. Each debenture is convertible into common at \$27.90 per share of common equal to 35.842 shares of common per 1M debenture.

- With the price of the ABCD at $8\frac{3}{4}$ -9 or 8.75-9 and a short position of 100 shares of ABCD the short position would not be exempt.

- If the price of ABCD was \$28 with a short position of 100 shares, 35 shares would be exempt and the remaining 65 shares would not be exempt.]

[(ii) Short a security and long a call which has a strike price at or in the money and which is exercisable within 90 calendar days into the underlying short security.]

[Example: Long 1 call of EFGH at a price of either $44 \frac{1}{8}$ or \$44.10 with a strike price of 40 expiring within 90 calendar days.

- With the circumstances as above 100 shares would be exempt.
- If the strike price was 50 a short position of 100 shares would not be exempt.
- With any strike price and the call expiring in more than 90 days any short of the common would not be exempt.]

[(iii) Short a security and long a position in warrants or rights which are exercisable within 90 days into the short security. To the extent that the long warrants or rights are "out of the money," then the short position shall be exempt up to the market value of the long warrants or rights.]

[Example: Long 100 warrants of IJKL (IJKLW: $2 \frac{1}{4}$ - $2 \frac{3}{4}$ or 2.25-2.75). Each warrant is exercisable into 1 share of common at \$2. (IJKL: $4 - 4 \frac{1}{2}$ or \$4-4.50).

- With the circumstances as above a short position of 100 shares would be exempt.
- If the price of IJKL is \$1.50 and the market value of long warrants is $\frac{1}{4}$ of a point, or \$.25, a short position of 16 shares would be exempt.]

[(iv) Short a security and long a single stock future of the underlying security.]

[Example: Long 1 single stock future of MNOP.

- With the circumstances as above (and assuming a contract size of 100) 100 shares would be exempt.

- Even if the expiration date for the single stock future was more than 90 calendar days, 100 shares would be exempt.]

[(B) Bona Fide Fully Arbitraged]

[The following transactions shall be considered bona fide fully arbitraged:]

[(i) Long a security purchased in one market together with a short position from an offsetting sale of the same security in a different market at as nearly the same time as practicable for the purpose of taking advantage of a difference in price in the two markets.]

[Example: Purchase 100 shares of EFGH on the London Stock Exchange and simultaneously effecting a short sale of 100 shares of EFGH on Nasdaq.

- Under the above circumstances, the 100 shares short would be exempt.]

[(ii) Long a security which is without restriction other than the payment of money exchangeable or convertible within 90 calendar days of the purchase into a second security together with a short position from an off-setting sale of the second security at or about the same time for the purpose of taking advantage of a concurrent disparity in the prices of the securities.]

[Example: Long 100 shares of MNOP (MNOP: 51-51 ¹/₄ or 51.00-51.25) which is being acquired by QRST Corp. (QRST: 52 ¹/₈ - 52 ³/₈ or 52.10-52.30) at the rate of 1.15 shares per MNOP share.

- If the exchange is to take place within 90 days then a short of 115 shares of QRST would be exempt from the mandatory buy-in. Also, if the exchange was to take place at a date later than 90, all short positions in the above example would be subject to the mandatory buy-in.]

[(C) The transaction date of the short sale shall govern when a fully hedged or fully arbitrated position exists.]

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11830. Reserved. [Mandatory Close-Out for Short Sales]

[(a) A contract involving a short sale in Nasdaq securities described in paragraph (b) hereof, for the account of a customer or for a member's own account, which has not resulted in delivery by the broker/dealer representing the seller within 10 business days after the normal settlement date, must be closed by the broker/dealer representing the seller by purchasing for cash or guaranteed delivery securities of like kind and quantity.]

[(b) This requirement shall apply to Nasdaq securities, as published by the Association, which have clearing short position of 10,000 shares or more and that are equal to at least one-half (1/2) of one percent of the issue's total shares outstanding.]

[(c) This mandatory close-out requirement shall not apply to bona fide market making transactions and transactions that result in fully hedged or arbitrated positions.]

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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 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 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

On June 23, 2004, the SEC adopted certain provisions of a new short sale regulation, designated Regulation SHO (Reg SHO). Reg SHO includes several new provisions that are duplicative of or overlap with existing NASD rules. These include: (1) SEC Rule 200(g) of Reg SHO, which requires that sell orders in all equity securities be marked "long," "short," or "short exempt"; (2) SEC Rule 203(a) of Reg SHO, which provides that, with limited exception, if a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so; (3) SEC Rule 203(b)(1) of Reg SHO, which applies a uniform rule, with certain limited exceptions, requiring all broker-dealers, prior to effecting short sales in equity securities, to "locate" securities available for borrowing; and (4) SEC Rule 203(b)(3) of Reg SHO, which requires registered clearing agency participants to close out all failures to deliver 10 days after the normal settlement date for securities in which a substantial amount of failures to deliver have occurred, referred to as "threshold securities."⁴

⁴ Reg 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

As noted in the adopting release for Reg SHO, as well as in discussions between SEC and NASD staff, the SEC has indicated that it expects that Reg SHO provisions will supplant existing overlapping self-regulatory organization (SRO) rules. Accordingly, NASD believes that certain of its rules are duplicative of or overlap with Reg SHO requirements and therefore should be repealed. As a result, NASD is proposing to repeal NASD Rule 3110(b)(1), Rule 3210, Rule 3370(b) and Rule 11830. Specifically, Rule 3110(b)(1),⁵ overlaps or is duplicative with Rule 200(g) of Reg SHO, which governs order marking in all equity securities. In addition, Rule 3210,⁶ Rule 3370(b)⁷ and Rule 11830⁸ overlap with or are duplicative of Rule 203 of Reg SHO.

As noted below, NASD is filing the proposed rule change for immediate effectiveness, with an operative date of January 3, 2005.⁹ NASD will announce the implementation date in a Notice to Members to be published prior to January 3, 2005.

Act (a reporting company) where for five consecutive settlement days there are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per security; that the level of fails is equal to a least one-half of one percent of the issue's total shares outstanding (TSO); and the security is included on a listed published by a self-regulatory organization.

⁵ Rule 3110(b)(1) requires that an associated person indicate on the order ticket whether an order is "long" or "short."

⁶ Rule 3210 prohibits a member from selling a security for its own account or buying a security as a broker for a customer, if the member has a fail to deliver in that security that is 60 days old or older, or 90 days old or older for foreign securities.

⁷ Rule 3370(b) requires, among other things, that (1) no member accept a long sale order from a customer unless the member has possession of the security, the customer is long in his account, the member makes an affirmative determination that the customer owns the security and will deliver it on settlement date or that it is in good deliverable form on deposit with a member or other permissible entity; and (2) no member effect a "short" sale order for a customer, non-member broker-dealer or proprietary account in any security unless the member makes an affirmative determination that the member will receive delivery of the security or that the member can borrow the security for delivery by settlement date, subject to certain exemptions.

⁸ Rule 11830 generally mandates delivery of a security within 10 days of the settlement date for short sales executed in Nasdaq securities that, on the trade date of the transaction, had a clearing short position equal to at least one-half of one percent of the issue's total shares outstanding.

⁹ The Commission understands that the operative date of this proposed rule change is the same date as the compliance date of Rules 200 and 203 of Regulation SHO. See Securities Exchange

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹⁰ which requires, among other things, that NASD rules must 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 believes that the SEC's Reg SHO will address potentially abusive short selling activities in the marketplace that NASD Rule 3110(b)(1), Rule 3210, Rule 3370(b) and Rule 11830 were intended to address, and therefore repeal of these rules is consistent with the Act.

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

NASD 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

Because the foregoing proposed rule change does not: (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(6) thereunder.

Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

¹⁰ 15 U.S.C. 78o-3(6).

In accordance with Rule 19b-4, NASD submitted written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing. NASD proposes to make the proposed rule change operative on January 3, 2005.

At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-NASD-2004-175 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-175. This file number should be included on the subject line if e-mail is used. To help the Commission process and

review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 at the principal office of NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2004-175 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Margaret H. McFarland
Deputy Secretary

¹¹ 17 CFR 200.30-3(a)(12).