

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53224; File No. SR-NASD-2005-112)

February 3, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to Amendments to Rule 3360 to Expand Short Interest Reporting to OTC Equity Securities

I. Introduction

On September 20, 2005, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission” or “SEC”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend NASD Rule 3360 to expand short interest reporting requirements to over-the-counter (“OTC”) equity securities.³ The proposed rule change was published for comment in the Federal Register on November 3, 2005.⁴ The Commission received seven comment letters on the proposal.⁵ The NASD filed a response to the comment letters on January 20, 2006.⁶ This order approves the proposed rule change.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The term “OTC equity securities” means any equity securities that are neither included in the Nasdaq Stock Market nor traded on a national securities exchange.

⁴ See Securities Exchange Act Release No. 52679 (Oct. 26, 2005), 70 FR 66875 (Nov. 3, 2005) (the “Proposing Release”).

⁵ See email from Greg Hogberg to enforcement@sec.gov, dated December 30, 2005 (attaching letter from Dr. Jim DeCosta to Jonathan G. Katz, Secretary, SEC, dated November 24, 2005); email from Donald L. Smith to rule-comments@sec.gov, dated December 16, 2005; letter from Dr. Jim DeCosta to Jonathan G. Katz, Secretary, SEC, dated November 24, 2005 (“DeCosta”); email from Paul Vuksich to rule-comments@sec.gov, dated November 22, 2005 (“Vuksich”); email from David Patch to rule-comments@sec.gov, dated November 17, 2005 (“Patch”); email from Daniel Opdyke to rule-comments@sec.gov, dated November 10, 2005; email from Chris Meredith to rule-comments@sec.gov, dated November 1, 2005 (“Meredith”).

⁶ See letter from Andrea D. Orr, Assistant General Counsel, NASD, to Nancy M. Morris, Secretary, SEC, dated January 20, 2006.

II. Description of the Proposal

The proposal would amend Rule 3360, Short-Interest Reporting, to require that members maintain and report on a monthly basis total short positions in OTC equity securities in all customer and proprietary firm accounts.⁷ Currently, Rule 3360(a) requires members to maintain a record of total short positions⁸ in all customer and proprietary firm accounts in Nasdaq securities (and listed securities if not reported to another self-regulatory organization (“SRO”)) and requires members to report such information to the NASD on a monthly basis. The NASD believes that expanding the monthly short interest reporting requirements to OTC equity securities will increase the information available to public investors and other interested parties related to trading in OTC equity securities. Accordingly, the NASD proposes to amend Rule 3360(a) to require that members maintain and report to the NASD short sale positions for OTC equity securities. For purposes of the proposed rule change, OTC equity securities would be defined as any equity security that is not listed on The Nasdaq Stock Market or a national securities exchange.

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. In the proposed rule change, the NASD stated that in recognition of the

⁷ Non-self-clearing broker-dealers generally are considered to have satisfied their reporting requirement by making appropriate arrangements with their respective clearing organizations. See NASD Notice to Members 03-08 (Jan. 2003).

⁸ Rule 3360(b) provides that short positions required to be reported under the rule are those resulting from short sales as the term is defined in Rule 200 of Regulation SHO under the Act (“Regulation SHO”), with limited exceptions. Rule 200 of Regulation SHO provides, in part, the following: “The term ‘short sale’ shall mean any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.” 17 CFR 242.200(a).

technological and systems changes the proposed rule change may require, the effective date for the proposed rule change will be 90 days following publication of the NASD's Notice to Members announcing Commission approval.⁹

In the Proposing Release,¹⁰ the Commission specifically requested comment regarding whether the implementation period for the proposed rule change could be shorter.¹¹ The Commission did not receive any comments regarding this specific request for comment. Thus, the Commission has determined not to request that the NASD shorten the implementation period.

III. Summary of Comments

The Commission received seven comment letters on the proposal.¹² The commenters generally supported the proposal. Some commenters, however, recommended additional changes to the proposed rule and to other rules relating to short selling. The following is a summary of the major concerns the commenters raised.

Two commenters questioned the exceptions to the short interest reporting requirements contained in current Rule 3360 and in the proposed rule change.¹³ Both current Rule 3360 and the proposed rule change provide that NASD members must report short interest positions that result from "short sales," as that term is defined in Rule 200

⁹ See 70 FR at 66876.

¹⁰ See supra note 4.

¹¹ 70 FR at 66876.

¹² See supra note 5.

¹³ See Patch at 1; Meredith at 1.

of Regulation SHO,¹⁴ with the exception of positions that meet the requirements of subsections (e)(1), (6), (7), (8) and (10) of Rule 10a-1 under the Act.¹⁵

The commenters recommended that the exceptions be eliminated from the proposed rule change and all short interest positions be reported and publicly disseminated.¹⁶ One commenter argued that all short interest positions should be disclosed to the investing public so that investors have an understanding of exactly how much supply is actually in the system because the short interest position affects the overall valuation of a security.¹⁷

One commenter proposed amendments to Rule 3360 that would require issuers to cause their transfer agents to report long and short interest positions to the NASD at the

¹⁴ See 17 CFR 242.200(a).

¹⁵ See NASD Rule 3360(b); supra note 4. Rule 10a-1 provides that, subject to certain exceptions, a short sale in an exchange-registered security may be effected only pursuant to the price test restrictions contained in Rule 10a-1. Subsection (e) of Rule 10a-1 contains exceptions to the price test restrictions. The exceptions in Rule 10a-1(e) were designed to permit certain types of trading activities that were intended to benefit the markets or that were believed to carry little risk of the kind of manipulative or destabilizing trading that the rule was designed to address. See Securities Exchange Act Release No. 48709 (Oct. 28, 2003), 68 FR 62972 (Nov. 6, 2003). Subsection (e)(1) of Rule 10a-1 permits short sales to be effected without regard to the price test restrictions in the rule if the seller owns the security sold and intends to deliver such security as soon as possible without undue inconvenience or expense. See 17 CFR 240.10a-1(e)(1). Subsection (e)(6) of Rule 10a-1 contains an exception for certain sales of a security effected with the approval of an exchange which are necessary to equalize the price of such security with the current price of such security on another national securities exchange, which is the principal exchange market. See 17 CFR 240.10a-1(e)(6). Subsection (e)(7) of Rule 10a-1 contains an exception for certain bona fide domestic arbitrage transactions. See 17 CFR 240.10a-1(e)(7). Subsection (e)(8) of Rule 10a-1 contains an exception for certain international domestic arbitrage transactions. See 17 CFR 240.10a-1(e)(8). Subsection (e)(10) of Rule 10a-1 generally excepts sales of securities by underwriters or syndicate members participating in a distribution in connection with an over-allotment, and any lay-off sales by such a person in connection with a distribution of securities through rights or a standby underwriting commitment. See 17 CFR 240.10a-1(e)(10).

¹⁶ See Patch at 1; Meredith at 1.

¹⁷ See Patch at 1.

close of each trading day.¹⁸ This commenter's recommendation would also require transfer agents on behalf of issuers to report certain share information to the NASD at the close of each trading day, such as authorized shares, total shares outstanding, and shares held in street name.¹⁹

Some commenters asserted that further action in the short selling area is necessary, in particular to address naked short selling abuses and what they believe to be certain loopholes in Regulation SHO.²⁰ Other commenters raised concerns regarding hedge fund regulation, the National Securities Clearing Corporation's Continuous Net Settlement System and the Depository Trust & Clearing Corporation's stock loan program.²¹

IV. NASD's Response

In its response letter,²² the NASD stated that it believed that all the comments were outside the scope of its rule filing because the proposed rule change is limited to expanding the current short interest reporting requirements to OTC equity securities.²³ The NASD stated in its letter that because the changes recommended by the commenters were not germane to the proposal, were beyond the purview of the NASD, or related to amendments to another SRO's rules or SEC rules, the NASD was not responding to those

¹⁸ See Vuksich at 1.

¹⁹ See id.

²⁰ See e.g., DeCosta.

²¹ See e.g., Meredith at 1; DeCosta at 2-8.

²² See supra note 6.

²³ Id. at 3.

recommendations specifically in its response letter.²⁴ In addition, the NASD stated that it would review and analyze these recommendations in the same manner in which it would consider any requests for rulemaking, and, based on such review and analysis, would determine whether further action on these recommendations is appropriate.²⁵

With respect to comments regarding the exceptions to short interest reporting contained in current NASD Rule 3360 and the proposed rule change, the Commission urges the NASD to conduct an in-depth review of the exceptions to short interest reporting to determine whether future rulemaking regarding the exceptions is appropriate.

V. Discussion and Commission Findings

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange and, in particular, the requirements of Section 15A of the Act²⁶ and the rules and regulations thereunder. Specifically, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,²⁷ which requires, among other things, that the NASD's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, remove impediments to a free and open market and a national market system, and, in general, to protect investors and the public interest.²⁸

²⁴ Id.

²⁵ Id.

²⁶ 15 U.S.C. 78o-3.

²⁷ 15 U.S.C. 78o-3(b)(6).

²⁸ In approving this proposed rule change the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

The Commission believes that expanding short interest reporting to OTC equity securities will protect investors and the public interest by requiring NASD members to increase the information available to investors and other interested parties related to trading in OTC equity securities.

VI. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,²⁹ that the proposed rule change (SR-NASD-2005-112) be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁰

Nancy M. Morris
Secretary

²⁹ 15 U.S.C. 78s(b)(2).

³⁰ 17 CFR 200.30-3(a)(12).