



January 3, 2005

Mr. Jonathan Katz  
Secretary  
United States Securities and Exchange Commission  
450 5th Street, N.W.  
Washington, D.C. 20549

Subject: Petition for Commission Action to Require Short interest Reporting  
for all Over-the-Counter Equity Securities

Dear Mr. Katz:

Pink Sheets LLC ("Pink Sheets") respectfully petitions the Securities and Exchange Commission (the "Commission") to mandate an amendment to Rule 3360 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. (the "NASD") that would require NASD members to maintain a record of total "short" positions in all customer and proprietary firm accounts in **all publicly traded equity securities** and report this information to the NASD for public dissemination of the aggregate positions by security<sup>1</sup>. Under the current rule, NASD members are only required to maintain such records and make reports regarding securities included in The NASDAQ Stock Market or listed on a national securities exchange. The rule excludes OTC equity securities, thereby denying investors and the markets for these instruments the protections of transparency and regulatory oversight provided by Rule 3360. The Commission's action is urgently needed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors and the public interest.

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<sup>1</sup> The NASD should also make such information publicly available in the equivalent way Nasdaq short interest volume is currently provided to the public.



Pink Sheets is the leading provider of pricing and financial information for the over-the-counter (OTC) securities markets and, among other things, operates an Internet-based, electronic quotation and trade negotiation service for OTC equities and bonds for market makers and other broker-dealers registered under the Exchange Act.

## **The Proposed Amendment to Rule 3360**

The amendment to existing Rule 3360 that we propose, with inserted language in italics and deleted language in brackets, is as follows:

### 3360. Short interest Reporting

(a) Each member shall maintain a record of total "short" positions in all customer and proprietary firm accounts in [securities included in The Nasdaq Stock Market and in each other security listed on a registered national securities exchange] *all Nasdaq National Market and Nasdaq SmallCap securities, all Consolidated Quotation Service (CQS) securities traded in the over-the-counter market, and all OTC Equity Securities as defined in Rule 6600* that are [and] not otherwise reported to another self-regulatory organization and shall regularly report such information to NASD in such a manner as may be prescribed by NASD.

The remainder of the Rule would not be changed.

## **History of Short interest Reporting Rules**

The NASD originally adopted the predecessor to Rule 3360 in 1986 in response to an extensive study of short sale practices in the over-the-counter market.<sup>2</sup> By that time, national securities exchanges had required short interest disclosure by their members for many years. The purpose of the study was to determine the need for additional regulation of short sale practices. The NASD adopted two of the study's proposals: First, to require NASD members to report aggregate short positions in NASDAQ securities in all customer and proprietary firm accounts on a monthly basis. Second, to make the data on aggregate short positions publicly available.

In its 1986 rule-making proposal, the NASD provided two reasons for the reporting and dissemination of aggregate short positions: First, the reports would improve the NASD's ability to surveil short-sale practices in the over-the-counter market. Second, the dissemination of the reports to the public would provide market participants with complete information on which to base their trading and investment decisions.

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<sup>2</sup> Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Reporting of Aggregate Short Positions in NASDAQ Securities, SR-NASD-86-30, Release No. 34-23730 (October 20, 1986).



In 1991, the Commission published for comment a rulemaking request submitted by the Association of Publicly Traded Companies (“APTC”).<sup>3</sup> This petition asked the Commission to impose a reporting requirement on individuals or groups holding short positions of five percent or more of any publicly traded issuer’s securities and was intended to parallel the current requirement of Rule 13d-1 under the Securities Exchange Act of 1934 (the “Exchange Act”) to report long positions. The Commission has not taken any further action on this proposal.

The Commission has approved other amendments to NASD Rule 3360, which are not relevant to this rule-making petition.

### **Reasons for this Rule-Making Petition**

Section 15A(a) of the Exchange Act states that the Commission may, by rule, prescribe rules for the NASD “as necessary or appropriate in the public interest or for the protection of investors.” Section 15A(b)(6) further requires that the rules of the NASD must be designed to “prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest.” The Commission therefore has the authority under Section 15A to require the NASD to create rules providing for short interest reporting with respect to all publicly traded equity securities by NASD members, provided the Commission finds that such reporting is required to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, or protect investors and the public interest.

#### *Investors Lack Required Information*

At the present time, there is no short interest disclosure for stocks traded on the OTC Bulletin Board® or the Pink Sheets. The lack of short position transparency leaves investors unable to adequately understand the reasons for selling pressure in an OTC equity security. Short interest disclosure is required to enable proper surveillance by the NASD and to provide market participants with complete information on which to base their trading and investment decisions in these important markets.

A properly functioning market will reflect the expectations of investors regarding an issuer’s business and prospects. When investors are pessimistic about an issuer, the market for the issuer’s securities should show a downward trend. When disaster strikes an issuer’s business, the market should decline rapidly in response to this adverse event. However, selling pressure may result from market activity unrelated to the

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<sup>3</sup> Public Disclosure of Material Short Security Positions, Release No. 34-29278 (June 7, 1991).



issuer's business and prospects, in which case the market fails in its essential price-setting function.

#### *Required for Proper Regulatory Oversight*

A market fails to function properly when rapid downward movements in price result from manipulative activities. In a recent decision, NASD Regulation found that in 1995, John Fiero and a group of professional traders at several NASD member firms collectively engaged in a "bear raid" to drive down the prices of certain securities underwritten by Hanover Sterling and Company. See, *Department Of Enforcement v. Carlson, Fiero and Fiero Brothers, Inc.*, NASD Regulation Disciplinary Proceeding No. CAF980002 (December 6, 2000), *affirmed*, NASD National Adjudicatory Council (October 28, 2002). In a bear raid, short sellers attempt to drive down the price of the security by artificially creating an imbalance of sell-side interest. In this case, massive naked short selling by Mr. Fiero and other professional traders ultimately caused the failure of Hanover Sterling and its clearing firm, Adler Coleman and substantial losses by hundreds of ordinary investors.

Manipulative naked short selling by broker-dealers operates as a fraud on the market causing investors to lose confidence in the fairness and legitimacy of OTC markets. The NASD needs the reports provided under Rule 3360 extended to all OTC equity securities to properly police such actions.

#### *Allows the True Sellers to Hide*

On the other hand, we believe that issuers and investors often blame naked short sales for market declines when other activities are responsible. For example, the selling of control or restricted securities may cause a market decline, and such sales may have a manipulative purpose. In addition, sales of control or restricted securities raise regulatory concerns about improper public distributions of unregistered securities. The lack of short interest reporting in OTC equity securities causes confusion on the part of investors and issuers, and inhibits proper regulatory oversight.

It is our experience that downward stock price movements are usually blamed on manipulative naked short selling by market makers. At the present time, legal actions are frequently brought against market makers in the OTC markets charging them with manipulative short selling activity.<sup>4</sup> We believe these legal actions reflect confusion on the part of investors indicating a critical need for better market information than is currently available to the marketplace. More disturbing, legal actions against market participants indicate a lack of confidence in the important market for OTC equity

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<sup>4</sup> Investors and issuers have frequently brought legal actions against market makers alleging manipulative short selling and during discovery found the market makers did not have any material short positions or were actually net long the stock over the period of alleged short selling.



securities. Short interest disclosure would help investors and issuers to determine the source of selling pressure, which often has nothing to do with short sales.

### *Facilitates Pump and Dumps*

The lack of short interest disclosure creates an opportunity for nefarious individuals and promoters to use the public's perception that OTC selling pressure is due to widespread naked short selling to facilitate unlawful pump and dump manipulations. These unscrupulous manipulators fraudulently persuade investors to buy a stock on the theory that short sellers will eventually need to cover their short sales and thus be "squeezed" into paying higher prices for a limited supply of stock. This fraud relies on the absence of adequate short interest disclosure, which would enable investors to determine the true source of selling pressure. The NASD's current failure to extend the transparency of Rule 3360 to all OTC equity securities leaves investors blind to the true extent of short interests, thus allowing and facilitating the "naked short squeeze" type of fraudulent pump and dump scheme.

### *Better Market Information Makes Better Markets*

Many publicly traded securities are not registered under Section 12(g) of the Exchange Act. Investors in such stocks often must make investment and trading decisions without good information regarding the number of outstanding shares and the amount of insider ownership. These conditions increase the need for short interest disclosure in such OTC equity securities.

For example, section 16(c) of the Exchange Act forbids short selling by corporate insiders. This salutary rule does not apply to issuers that do not have a class of securities registered under Section 12(g) of the Exchange Act ("non-reporting issuers"). As a result, the market for a non-reporting issuer's securities may be manipulated downward by corporate insiders who sell short to take advantage of their superior access to information.

Finally, selling pressure may be introduced into a market when unregistered securities initially offered in a private placement first become available for sale in the market. In principle, these sales of formerly unregistered securities should not provoke a strong market reaction. The issuer's prospects have not changed, and there has not been any increase in the amount of outstanding securities. We believe investors often confuse legitimate long sales of formerly restricted securities with manipulative short selling. Sharp declines in the market following such sales suggest that the market has failed to price the security properly due to a lack of information among investors as to the reasons for the selling pressure.



Adequate disclosure is essential for the operation of efficient, well-organized markets. In particular, short interest disclosure defeats efforts to disrupt markets; it is a truism that “sunlight is the best disinfectant.” Manipulation and other fraudulent activities fail when investors can properly identify the reasons for selling pressure and react accordingly.

When investors can identify selling pressure as originating from short sales, that information can be taken into account in making trading and investment decisions. Short interest disclosure would enable investors to identify “bear raids” and insider short sales and react accordingly. Long sales of formerly restricted stock would not be confused with naked short selling. On the other hand, when selling pressure results from investor pessimism over an issuer’s prospects, short interest disclosure would enable the market to adjust properly to such negative expectations. **Pink Sheet’s most common request from investors and the public is for short interest disclosure in OTC equity securities.**

We are puzzled that the NASD has not reacted favorably to repeated requests to extend the short interest disclosure rule to cover all OTC equity securities. In its 1986 proposal, the NASD did not explain its reasons for limiting short interest reporting and dissemination to NASDAQ securities. Then, as now, there are many more publicly traded OTC non-NASDAQ equity securities than there are NASDAQ securities. The need for surveillance of short sale practices in the non-NASDAQ OTC markets is, if anything, greater because there is less information otherwise available to protect investors in these markets. Moreover, there is generally less liquidity in the trading of these securities, so that investors have a greater need to know whether selling pressure is the result of short sale activities or long sales that reflect investor pessimism.

We therefore respectfully submit that short interest reporting for all publicly traded equity securities is required to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors and the public interest. The Commission should therefore insist that the NASD amend Rule 3360 to require such reports by its members.

## **Conclusion**

Investors in recent years have shown increasing interest in the securities of less well-known and smaller issuers. In part, this enthusiasm reflects the torrent of information available through the Internet regarding investment strategies. As many experienced investors have known for decades, great opportunities exist in the market for emerging companies for those investors with sufficient patience and insight to discover successful new enterprises. This trend of increasing investor interest can be expected to continue as more investors become familiar with the markets for emerging issuers.



Investments in emerging issuers will always be risky; smaller companies have fewer resources to withstand economic shocks than their larger counterparts. Nevertheless, there is no good reason to subject investors to the fear that they will be cheated by manipulative short selling activities when good disclosure to alleviate confusion and protect against such activities is readily available and inexpensive to provide.

In its 1986 proposal, the NASD stated that short interest disclosure was necessary to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, and protect investors and the public interest. We heartily agree, and only ask that the protections offered by this salutary rule be extended to those investors who commit capital to publicly traded non-NASDAQ equity securities.

We urge the Commission to require the NASD to take immediate action to extend short interest reporting to ALL publicly traded equity securities.

Respectfully submitted,

R. Cromwell Coulson  
Chief Executive Officer