

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53596; File No. SR-NASD-2004-044)

April 4, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 thereto Relating to Short Sale Delivery Requirements

I. Introduction

On March 10, 2004, 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 apply a delivery framework to certain non-reporting equity securities similar to that imposed on reporting equity securities by Regulation SHO.³ The NASD submitted Amendment No. 1 to its proposed rule change on October 6, 2005 and submitted Amendment No. 2 to its proposed rule change on October 28, 2005.⁴ The proposed rule change, as amended, was published for

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (Aug. 6, 2004) (“Regulation SHO Adopting Release”). The Commission adopted Regulation SHO to, among other things, impose a requirement on a participant of a registered clearing agency to take action to close out fail to deliver positions in “threshold securities.” Regulation SHO defines a “threshold security” as any equity security that is registered under Section 12 of the Act, or where the issuer of such security is required to file reports under Section 15(d) of the Act, and which security has, for five consecutive settlement days, had aggregate fails to deliver at a registered clearing agency of at least 10,000 shares that are also equal to at least 0.5% of the issuer’s total shares outstanding (“TSO”). See 17 CFR 242.203(c)(6). In the Regulation SHO Adopting Release, the Commission noted that because the calculation of the threshold that would trigger the delivery requirements under the rule depends on identifying the aggregate fails to deliver as a percentage of the TSO, the Commission believed it was necessary to limit the close out requirement to companies that are subject to the reporting requirements of the Act. See Regulation SHO Adopting Release, 69 FR at 48016, fn. 82.

⁴ On account of the adoption of Regulation SHO, Amendment No. 1, among other things, narrowed the scope of the proposal to those equity securities not otherwise covered by the delivery requirements of Rule 203(b) of Regulation SHO. Amendment No. 2 replaced and superseded Amendment No. 1 in its entirety and made technical changes to the proposed rule change.

notice and comment in the Federal Register on November 16, 2005.⁵ The Commission received nine comment letters on the proposal.⁶ The NASD filed a response to the comment letters on March 15, 2006.⁷ This order approves the proposed rule change, as amended.

II. Description of the Proposal

The proposed rule change would require participants⁸ of registered clearing agencies⁹ to take action to immediately close out fail to deliver positions that exist for thirteen consecutive settlement days in non-reporting threshold securities by purchasing securities of like kind and quantity. A “non-reporting threshold security” is “any equity security of an issuer that is not registered pursuant to Section 12 of the Act¹⁰ and for which the issuer is not required to file reports pursuant to Section 15(d) of the Act¹¹: (A) for which there is an aggregate fail to deliver position for five consecutive settlement dates at a registered clearing agency of 10,000 shares or more and for which on each settlement day during the five consecutive day period, the reported last sale during the

⁵ See Securities Exchange Act Release No. 52752 (Nov. 8, 2005), 70 FR 69614 (Nov. 16, 2005) (“Proposing Release”).

⁶ See Letter from Paul Vuksich, II, dated December 22, 2005; letter from Amal Aly, Vice President and Associate General Counsel, Securities Industry Association, on behalf of the Securities Industry Association Regulation SHO Working Group, dated December 14, 2005 (“SIA Letter”); letter from Jim L. Hoch, dated December 14, 2005; letter from Paul Vuksich, II, dated December 12, 2005 (“Vuksich Letter”); letter from Donald J. Stoecklein, President, Stoecklein Law Group, dated December 13, 2005 (“Stoecklein Law Group Letter”); letter from Peter J. Chepucavage, General Counsel, Plexus Consulting, dated December 1, 2005; letter from Bob O’Brien, dated November 17, 2005; letter from David Patch, dated November 14, 2005; and letter from Richard M. Rosenthal, Esq, dated November 10, 2005.

⁷ See letter from Andrea D. Orr, Assistant General Counsel, NASD, to Nancy M. Morris, Secretary, SEC, dated March 15, 2006 (“Response to Comments”).

⁸ A “participant” means a participant as defined in Section 3(a)(24) of the Act, that is an NASD member. See Proposing Release, *supra* note 5, 70 FR at 69615.

⁹ A “registered clearing agency” is a clearing agency, as defined in Section 3(a)(23)(A) of the Act, that is registered with the SEC pursuant to Section 17A of the Act.

¹⁰ 15 U.S.C. 78j

¹¹ 15 U.S.C. 78q(d)

normal market hours for the security on that settlement day would value the aggregate fail to deliver position at \$50,000 or more, provided that, if there is no reported last sale on a particular settlement day, then the price used to value the position on such settlement day would be the previously reported last sale; and (B) is included on a list published by the NASD.”

In addition, if the fail to deliver position is not closed out in the requisite time period, a participant or any broker-dealer for which it clears transactions, including market-makers, would be prohibited from accepting any short sale order in the non-reporting threshold security from another person, or effecting a short sale in the non-reporting threshold security for its own account, without borrowing the security or entering into a bona-fide arrangement to borrow the security, until the participant has closed out the fail to deliver position by purchasing securities of like kind and quantity.

Under the proposed rule change, NASD would publish a list daily of the non-reporting threshold securities.¹² In order to be removed from the non-reporting threshold securities list, a security must not meet or exceed the threshold requirements in the proposed rule change for five consecutive settlement days.¹³

III. Summary of Comments

The Commission received nine comment letters on the proposal.¹⁴ Several commenters supported the proposal.

¹² Proposing Release, supra note 5, 70 FR at 69616.

¹³ Id., 70 FR at 69615.

¹⁴ See supra note 6.

A. Delivery Requirements for Non-Reporting Threshold Securities

Several commenters supported applying a delivery framework to non-reporting threshold securities. Some commenters, however, objected to certain provisions of the proposed rule change.

i. Uniform Short Sale Delivery Requirements

One commenter asserted that a uniform short sale delivery requirement for reporting and non-reporting equity securities would be preferable.¹⁵ This commenter argued that the adoption of the proposed rule change would upset the regulatory uniformity that Regulation SHO¹⁶ was intended to create because it would result in additional rules that apply only to NASD member firms.¹⁷ In addition, this commenter expressed concern that separate rules for reporting and non-reporting equity securities could be subject to disparate revisions and/or interpretations, thereby subjecting member firms to different delivery requirements, depending on which securities are at issue.¹⁸ This commenter urged the Commission to amend the Regulation SHO delivery requirements to also address non-reporting equity securities.¹⁹

In its Response to Comments, NASD agreed that uniformity with respect to rulemaking across self-regulatory organizations (“SROs”) is preferable to the extent possible and practicable.²⁰ In addition, NASD noted that if, in the future, the SEC determines to amend the Regulation SHO delivery requirements to apply to non-reporting

¹⁵ See SIA Letter, supra note 6, at 3.

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

¹⁹ Id.

²⁰ Response to Comments, supra note 7, at 4.

equity securities, NASD would consider repealing its rule.²¹ NASD also stated in its Response to Comments that, although NASD believes that the vast majority of trading in non-reporting securities occurs through NASD members, uniformity in this area can be achieved if other SROs propose similar requirements. NASD also noted that it did not believe it was appropriate to forestall an SRO proposal solely because other SROs have not put forth comparable requirements.²²

ii. \$50,000 Threshold Requirement

Some commenters opposed the \$50,000 value threshold requirement contained in the definition of a “non-reporting threshold security.” For example, one commenter argued that the dollar threshold value is inappropriate, stating that it is not an accurate indicator of non-reporting securities with excessive fails to deliver.²³ Another commenter believed that the dollar threshold value was too high, noting that such a value would harm small companies,²⁴ while another commenter argued that the dollar threshold value was too low and would capture a vastly expanded universe of threshold securities.²⁵

In its Response to Comments, NASD noted that it proposed the dollar threshold value to ensure that the non-reporting threshold security list would not be overly broad or impracticable.²⁶ NASD noted that it was concerned that having a security on the non-reporting threshold security list solely based on whether the failure to deliver position is equal to, or greater than, 10,000 shares may not represent a significant failure to deliver

²¹ Id.

²² Id.

²³ See Stoecklein Law Group Letter, supra note 6, at 1.

²⁴ See Vuksich Letter, supra note 6, at 1.

²⁵ See SIA Letter, supra note 6, at 5.

²⁶ Response to Comments, supra note 7, at 3.

position relative to the price of the security, particularly given that many non-reporting securities trade at less than \$1.00.²⁷ Thus, NASD believes that the \$50,000 value threshold strikes an appropriate balance to ensure that the threshold list is not overly broad or narrow.²⁸

iii. Impact on Liquidity in the Marketplace

One commenter believed that the proposed rule change may result in negative consequences for this class of securities, such as further reducing liquidity in already illiquid securities and having a greater impact on price than would be the case with reporting equity securities.²⁹

In its Response to Comments, NASD noted that similar concerns were raised in the context of Regulation SHO, to which the SEC responded that the requirements would only apply to a limited number of securities and would not apply to any fail to deliver positions existing prior to the security meeting the threshold requirements.³⁰ NASD noted in its Response to Comments that it believes these same assertions apply in the context of the proposed rule change as well, given the Commission's Office of Economic Analysis' ("OEA") estimates on non-reporting securities with fails to deliver of 10,000

²⁷ Id.

²⁸ Id. In addition, in its Response to Comments, NASD noted that NASD staff analyzed data relating to non-reporting securities over a five-day settlement period in February 2006 to get an indication of the number of non-reporting securities that would meet the proposed threshold requirements. During this time period, the analysis indicated that 44 securities would be deemed non-reporting threshold securities under the proposed threshold requirements. See Response to Comments, supra note 7, at fn. 20.

²⁹ See SIA Letter, supra note 6, at 4.

³⁰ Response to Comments, supra note 7, at 5.

shares or greater,³¹ and that NASD's proposal would further reduce this estimate due to the proposed additional \$50,000 value threshold requirement.³²

iv. Exemptive Authority

One commenter raised concerns with the provision that permits NASD to grant exemptive relief under certain specified conditions, arguing that NASD may abuse such discretion or the provision may provide a blanket exemption to firms.³³

In its Response to Comments, NASD commented that it believes this comment is without merit.³⁴ NASD believes that it is important to have the ability to address, through the exemptive process, situations that may warrant relief.³⁵ In addition, NASD noted that the proposed exemptive authority, by its terms, is specifically limited to those situations where granting such relief is consistent with the protection of investors and the public interest, and NASD will execute such authority consistent with this requirement.³⁶

B. Defined Terms

NASD proposed that the term "non-reporting threshold security" means "any equity security of an issuer that is not registered pursuant to Section 12 of the Act³⁷ and

³¹ In its Response to Comments, NASD noted that general estimates relating to the number of non-reporting securities with fails to deliver in excess of 10,000 shares were made publicly available as part of the Regulation SHO Adopting Release. NASD noted that the Regulation SHO Adopting Release provided that the Commission's OEA analyzed NSCC data on fails to deliver in excess of 10,000 shares for non-reporting issuers and estimated that only an additional 1% of all securities would be added to its estimate of the number of securities that would be subject to the close out requirements of Regulation SHO. See Response to Comments supra note 7, at 4 (referencing the Regulation SHO Adopting Release at fn. 86).

³² See id. at 5.

³³ See Stoecklein Law Group Letter, supra note 6, at 1.

³⁴ Response to Comments, supra note 7, at 4.

³⁵ Id.

³⁶ Id.

³⁷ 15 U.S.C. 78j

for which the issuer is not required to file reports pursuant to Section 15(d) of the Act:³⁸

(A) for which there is an aggregate fail to deliver position for five consecutive settlement dates at a registered clearing agency of 10,000 shares or more and for which on each settlement day during the five consecutive day period, the reported last sale during the normal market hours for the security on that settlement day that would value the aggregate fail to deliver position at \$50,000 or more, provided that, if there is no reported last sale on a particular settlement day, then the price used to value the position on such settlement day would be the previously reported last sale; and (B) is included on a list published by the NASD.”³⁹

The Commission agrees with NASD that imposing a lower dollar value threshold requirement, or eliminating it altogether, as some commenters suggested, might be impracticable or an overly-broad method of addressing any potential abuses in this sector of the marketplace. Similarly, the Commission agrees with NASD that increasing the dollar value threshold requirement could be too limiting. As noted above, a five-day settlement period analysis by NASD staff found that under the proposed threshold requirements, only approximately 44 securities would qualify as non-reporting threshold securities.⁴⁰

³⁸ 15 U.S.C. 78q(d)

³⁹ Proposing Release, supra note 5, 70 FR at 69615.

⁴⁰ See supra note 28.

C. Implementation

NASD suggests that the effective date of the proposed rule change will be 30 days following publication of NASD's Notice to Members announcing Commission approval⁴¹ and the Commission believes that this is reasonable.

IV. Discussion and Commission Findings

After careful review, the Commission finds, as discussed more fully below, that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association. The Commission finds specifically that the proposed rule change, as amended, is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Act.⁴²

Section 15A(b)(6) of the Act requires that NASD's rules are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.⁴³ Section 15A(b)(9) of the Act requires that NASD's rules do not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.⁴⁴

Section 3(f) of the Act directs the Commission to consider, in addition

⁴¹ 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.

⁴² 15 U.S.C. 78q-3(b)(6) and (b)(9).

⁴³ See 15 U.S.C. 78q-3(b)(6).

⁴⁴ See 15 U.S.C. 78q-3(b)(9).

to the protection of investors, whether approval of a rule change will promote efficiency, competition, and capital formation.⁴⁵ In approving the proposed rule change, the Commission has considered its impact on efficiency, competition, and capital formation. In particular, the Commission determined that requiring a delivery framework for non-reporting threshold securities similar to that required under Regulation SHO would increase investor confidence in this sector of the marketplace by helping to reduce fails to deliver which, in turn, would promote capital formation.

When the Commission adopted Regulation SHO, it did not apply the Regulation SHO delivery requirements to non-reporting threshold securities because the calculation of the threshold that would trigger the delivery requirements under Regulation SHO depends on identifying the aggregate fails to deliver as a percentage of the TSO that is generally obtained from periodic reports filed with the Commission. Thus, the Commission believed it was necessary to limit the delivery requirement to companies that are subject to the reporting requirements of the Act.

The Commission believes that applying a delivery framework similar to that contained in Regulation SHO to non-reporting threshold securities will protect investors and the public interest by helping to reduce fails to deliver in this sector of the marketplace. Thus, the Commission finds that the proposed rule change is consistent with Sections 15A(b)(6) and 15A(b)(9) of the Act.

⁴⁵ 15 U.S.C. 78c(f).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,⁴⁶ that the proposed rule change (SR-NASD-2004-044), as amended, be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁴⁷

Nancy M. Morris
Secretary

⁴⁶ 15 U.S.C. 78s(b)(2).

⁴⁷ 17 CFR 200.30-3(a)(12).