

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-52752; File No. SR-NASD-2004-044)

November 8, 2005

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 10, 2005, 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. On October 6, 2005, NASD filed Amendment No. 1 to the proposed rule change.³ On October 28, 2005, NASD filed Amendment No. 2 to the proposed rule change.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ On account of the adoption of Regulation SHO, Amendment No. 1 to SR-NASD-2004-044, among other things, narrows the scope of the proposed rule change to those equity securities not otherwise covered by the delivery requirements of Rule 203(b) of Regulation SHO.

⁴ Amendment No. 2 to SR-NASD-2004-044, which replaces and supersedes Amendment No. 1, makes technical changes to the proposed rule change.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing new Rule 3210 to require participants⁵ of registered clearing agencies⁶ (referred to herein as “clearing agency participants”) to take action on failures to deliver that exist for 13 consecutive settlement days in certain specified securities. In addition, if the fail to deliver position is not closed out in the requisite time period, a clearing agency participant or any broker-dealer for which it clears transactions would be prohibited from effecting further short sales in the particular specified security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the fail to deliver position is closed out.

Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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3210. [Reserved.]Short Sale Delivery Requirements

(a) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a non-reporting threshold security for 13 consecutive settlement days, the participant shall immediately thereafter close out the fail to deliver position by purchasing securities of like kind and quantity.

(b) The provisions of this rule shall not apply to the amount of the fail to deliver position that the participant of a registered clearing agency had at a registered clearing

⁵ See Section 3(a)(24) of the Act.

⁶ 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.

agency on the settlement day immediately preceding the day that the security became a non-reporting threshold security; provided, however, that if the fail to deliver position at the clearing agency is subsequently reduced below the fail to deliver position on the settlement day immediately preceding the day that the security became a non-reporting threshold security, then the fail to deliver position excepted by this paragraph (b)(1) shall be the lesser amount.

(c) If a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in a non-reporting threshold security for 13 consecutive settlement days, the participant and any broker or dealer for which it clears transactions, including any market maker that would otherwise be entitled to rely on the exception provided in paragraph (b)(2)(iii) of SEC Rule 203 of Regulation SHO, may not accept a short sale order in the non-reporting threshold security from another person, or effect 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 closes out the fail to deliver position by purchasing securities of like kind and quantity.

(d) If a participant of a registered clearing agency reasonably allocates a portion of a fail to deliver position to another registered broker or dealer for which it clears trades or for which it is responsible for settlement, based on such broker or dealer's short position, then the provisions of this rule relating to such fail to deliver position shall apply to the portion of such registered broker or dealer that was allocated the fail to deliver position, and not to the participant.

(e) A participant of a registered clearing agency shall not be deemed to have fulfilled the requirements of this rule where the participant enters into an arrangement with another person to purchase securities as required by this rule, and the participant knows or has reason to know that the other person will not deliver securities in settlement of the purchase.

(f) For the purposes of this rule, the following terms shall have the meanings below:

(1) the term “market maker” has the same meaning as in section 3(a)(38) of the Exchange Act.

(2) the term “non-reporting threshold security” means any equity security of an issuer that is not registered pursuant to section 12 of the Exchange Act and for which the issuer is not required to file reports pursuant to section 15(d) of the Exchange Act:

(A) for which there is an aggregate fail to deliver position for five consecutive settlement days at a registered clearing agency of 10,000 shares or more and for which on each settlement day during the five consecutive settlement day period, the reported last sale during 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 NASD.

A security shall cease to be a non-reporting threshold security if the aggregate fail to deliver position at a registered clearing agency does not meet or exceed either of the threshold tests specified in paragraph (f)(2)(A) of this rule for five consecutive settlement days.

(3) the term “participant” means a participant as defined in section 3(a)(24) of the Exchange Act, that is an NASD member.

(4) the term “registered clearing agency” means a clearing agency, as defined in section 3(a)(23)(A) of the Exchange Act, that is registered with the Commission pursuant to section 17A of the Exchange Act.

(5) the term “settlement day” means any business day on which deliveries of securities and payments of money may be made through the facilities of a registered clearing agency.

(g) Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may grant an exemption from the provisions of this rule, either unconditionally or on specified terms and conditions, to any transaction or class of transactions, or to any security or class of securities, or to any person or class of persons, if such exemption is consistent with the protection of investors and the public interest.

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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

Rule Filing History

On March 10, 2004, NASD filed with the Commission proposed rule change SR-NASD-2004-044, proposing amendments relating to short sale delivery requirements in all classes of equity securities. Given the SEC's adoption of Regulation SHO under the Act, which imposes delivery requirements related to short selling activities, on October 6, 2005, NASD filed Amendment No. 1 to SR-NASD-2004-044 to, among other things, narrow the scope of its proposal to those equity securities not otherwise covered by the delivery requirements of Rule 203 of Regulation SHO.⁷ NASD filed Amendment No. 2 to SR-NASD-2004-044 ("Amendment No. 2") to make certain technical changes.

⁷ On November 30, 2004, NASD filed for immediate effectiveness a rule change that repealed, among others, Rule 3210 and Rule 11830 in light of the requirements of the SEC's new short sale regulation, Regulation SHO under the Act. See Exchange Act Release No. 50822 (December 8, 2004), 69 FR 74554 (December 14, 2004) (File No. SR-NASD-2004-175). Therefore, deletion of those rules as part of this filing is no longer necessary.

Amendment No. 2 replaces and supersedes in its entirety the filing made on October 6, 2005.

Background

On June 23, 2004, the SEC adopted Regulation SHO under the Act, which provides a new regulatory framework governing the short selling of equity securities.⁸ Regulation SHO includes several new provisions relating to short sales, one of which imposes delivery requirements on clearing agency participants for certain securities that have a substantial level of failures to deliver. Specifically, Rule 203(b)(3) of Regulation SHO requires clearing agency participants to close out all failures to deliver in a “threshold security,” as defined in Regulation SHO, that have existed for thirteen consecutive settlement days. Regulation SHO defines a “threshold security” as any equity security of an issuer that is registered under Section 12 of the Act or that is required to file reports under Section 15(d) of the Act (commonly referred to as “reporting securities”) that (1) for five consecutive settlement days has had aggregate fails to deliver at a registered clearing agency of 10,000 shares or more; (2) the level of fails is equal to at least one-half of one percent of the issue’s total shares outstanding (“TSO”); and (3) is included on a list published by a self-regulatory organization.

If the fail to deliver is not closed out in the requisite time period, the clearing agency participant and any broker-dealer for which it clears transactions, including market makers, are prohibited from effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the

⁸ See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (“Regulation SHO Adopting Release”).

security until the fail to deliver position is closed out. To the extent that the participant can identify the broker-dealer(s) that have contributed to the fail to deliver position, the requirement to borrow or arrange to borrow prior to effecting further short sales should apply only to those particular broker-dealers.

Description of Proposed Rule Change

As noted above, the Regulation SHO delivery requirements apply only to reporting securities. NASD staff believes applying delivery requirements to non-reporting securities is an important step in reducing long-term fails to deliver in this sector of the marketplace.

Accordingly, NASD is proposing new Rule 3210, which would apply a delivery framework to non-reporting OTC equity securities substantially similar to that described above. Under the proposal, a non-reporting security that, for five consecutive settlement dates, has: (1) a failure to deliver equal to or greater than 10,000 shares; and (2) a reported last sale during normal market hours (9:30 a.m. to 4 p.m., Eastern Time (ET)) for the security on that settlement day that would value the aggregate fail to deliver position at \$50,000 or more; would be deemed a non-reporting threshold security and thus, subject to the delivery requirements proposed herein. In the event there is no reported last sale on any settlement day during such five-day period, the aggregate fail position would be valued based on the previously reported last sale.

In the Regulation SHO Adopting Release, the SEC indicated that it did not apply the Regulation SHO delivery framework to non-reporting securities because of the difficulties in capturing TSO information for those securities to determine whether they

met the Regulation SHO threshold requirements.⁹ NASD believes that under the proposed rule change described herein, the lack of TSO information for non-reporting securities would not be an issue, given that the only calculations necessary would be whether the failure to deliver position is equal to or greater than 10,000 shares and whether the failure to deliver position meets the dollar threshold test specified above.¹⁰

NASD will publish a list daily of the non-reporting securities that meet the threshold requirements under proposed Rule 3210. To be removed from the list, a security must not meet or exceed either of the threshold tests described above for five consecutive settlement days.

NASD believes that, as discussed previously, the proposed rule change would apply a delivery framework substantially similar to Regulation SHO to non-reporting securities. As such, NASD intends to apply and interpret these proposed requirements consistent with the SEC's application and interpretation of Regulation SHO, and to the

⁹ See id. Footnote 82.

¹⁰ According to the NASD, similar to the rationale behind the Regulation SHO threshold test relative to TSO, NASD has proposed the dollar threshold test to ensure that the non-reporting threshold security list is not overly broad or impracticable. NASD is 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 position relative to the price of the security, particularly given that many non-reporting securities trade at less than \$1.00. As noted in the Regulation SHO Adopting Release, there may be many different causes of fails to deliver that could be unrelated to a market participant engaging in naked short selling. See Regulation SHO Adopting Release. Thus, NASD staff believes that imposing too low of a threshold may be an overly broad method of addressing any potential abuses and also could disrupt the efficient functioning of the Continuous Net Settlement system operated by the National Securities Clearing Corporation.

extent there are subsequent amendments to Regulation SHO, NASD will consider amending its requirements accordingly.

Among other issues relating to the filing, NASD is seeking comment on the proposed threshold tests for non-reporting OTC equity securities described above. Specifically, NASD is seeking comment on whether the proposed thresholds are an accurate indicator of non-reporting OTC equity securities with excessive fails to deliver, including but not limited to, whether the \$50,000 aggregate fail to deliver position is the appropriate dollar threshold and whether the 10,000 shares or greater failure to deliver threshold is the appropriate share threshold, given the trading characteristics in this sector of the marketplace.

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. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹¹ 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 proposed rule change will reduce significant, long-term fails to deliver in the marketplace.

¹¹ 15 U.S.C. 78o-3(b)(6).

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

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(a) by order approve such proposed rule change, or

(b) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

The Commission notes that in Section 3210(b) of the proposed rule, consistent with the application of Regulation SHO, the NASD excludes from the close out requirement of Section 3210(a) of the proposed rule the amount of the fail to deliver position that the participant of a registered clearing agency had at a registered clearing agency on the settlement day immediately preceding the day that the security became a

non-reporting threshold security. The Commission specifically requests comment on this aspect of proposed Rule 3210.

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, 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-2004-044 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2004-044. 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 in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. Copies of such filing also 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-2004-044 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.¹²

Jonathan G. Katz
Secretary

¹² 17 CFR 200.30-3(a)(12).