



March 15, 2006

Ms. Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

**Re: Response to Comments to File No. SR-NASD-2004-044 – Proposed
Amendments Relating to Short Sale Delivery Requirements**

Dear Ms. Morris:

On March 10, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) proposed rule change SR-NASD-2004-044, proposing amendments relating to short sale delivery requirements in all classes of equity securities (“original proposal”). On June 23, 2004, the SEC adopted Regulation SHO under the Securities Exchange Act of 1934 (“Exchange Act”), which provides a new regulatory framework governing the short selling of equity securities.¹ Regulation SHO includes several new provisions relating to short sales, one of which imposes delivery requirements on clearing agency participants for certain reporting securities that have a substantial level of failures to deliver.²

Given the SEC’s adoption of Regulation SHO, NASD amended its original proposal to, among other things, narrow the scope of its proposal to those equity securities not otherwise covered by the delivery requirements of Regulation SHO.³ NASD’s proposal would require participants⁴ of registered clearing agencies⁵ (“clearing

¹ See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).

² The term “reporting security” refers to an 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 Act.

³ On October 6, 2005, NASD filed Amendment No. 1 to SR-NASD-2004-044 that proposes to amend Rule 3210 to apply a delivery framework to non-reporting OTC equity securities substantially similar to Regulation SHO. On October 28, 2005, NASD filed Amendment No. 2 to SR-NASD-2004-044 to make certain technical changes to the proposal.

⁴ See Section 3(a)(24) of the Exchange Act.

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agency participants”) to take action on failures to deliver that exist for 13 consecutive settlement days in certain non-reporting securities.⁶ 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.

On November 16, 2005, the Commission published for comment the proposed rule change in the Federal Register.⁷ The Commission received nine comment letters in response to the Federal Register publication of SR-NASD-2004-044.⁸ The commenters raised several issues relating to the proposal. NASD is hereby responding to the comments made therein.

Several commenters support short sale delivery requirements for non-reporting securities, with one commenter stating the proposal is long overdue.⁹ Certain commenters however, urge NASD to reinstitute the original proposal, arguing that it was more simple and effective than the current proposal.¹⁰

As noted above, NASD proposed the original proposal prior to the adoption of Regulation SHO. Given the adoption and implementation of Regulation SHO, NASD does not believe it is appropriate at this time to apply a different delivery framework to

⁵ A “registered clearing agency” is a clearing agency, as defined in Section 3(a)(23)(A) of the Exchange Act, that is registered with the SEC pursuant to Section 17A of the Exchange Act.

⁶ 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 proposed delivery requirements. 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.

⁷ See Exchange Act Release No. 52752 (November 8, 2005), 70 FR 69614 (November 16, 2005) (the “original Federal Register notice”). Note: The Commission published a second Federal Register notice regarding the proposed rule change to correct a date reference in the original Federal Register notice. See Exchange Act Release No. 52752A (November 17, 2005), 70 FR 70910 (November 23, 2005).

⁸ Comments were submitted by the following: Paul Vuksich, II; Amal Aly, Vice President and Associate General Counsel, Securities Industry Association (SIA), on behalf of the SIA Regulation SHO Working Group; Jim L. Hoch; Paul Vuksich; Donald J. Stoecklein, President, Stoecklein Law Group; Peter J. Chepucavage, General Counsel, Plexus Consulting; Bob O’Brien; David Patch; and Richard M. Rosenthal, Esq.

⁹ Chepucavage; Stoecklein; O’Brien; and Patch.

¹⁰ O’Brien and Patch.

this sector of the marketplace. Therefore, NASD amended its original proposal to apply a delivery framework to non-reporting OTC equity securities substantially similar to Regulation SHO. NASD intends to apply and interpret these proposed requirements consistent with the SEC's application and interpretation of Regulation SHO.

Some commenters oppose certain provisions of the proposal that do not track the provisions of Regulation SHO, in particular, the \$50,000 threshold.¹¹ One commenter believes the dollar threshold level is inappropriate, arguing it is not an accurate indicator of non-reporting equity securities with excessive fails to deliver.¹² Another commenter believes that the dollar threshold is too high, arguing it will harm small companies,¹³ while yet another commenter argues that the \$50,000 threshold is too low and would capture a vastly expanded universe of threshold securities.¹⁴ One commenter recommends that the \$50,000 threshold be eliminated entirely.¹⁵

In its 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 total shares outstanding ("TSO") information for those securities to determine whether they met the Regulation SHO threshold requirements. As noted in the proposed rule change, similar to the rationale behind the Regulation SHO threshold test relative to TSO, NASD 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. Because there may be different causes of fails to deliver, imposing too low of a threshold may be an overly broad method of addressing any potential abuses. Accordingly, NASD continues to believe that the \$50,000 threshold test strikes the appropriate balance to ensure that the threshold list is not overly broad or narrow.

Another commenter raises concerns with the provisions that permit 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.¹⁶ Notably, the commenter has not asserted any basis for its concern. NASD believes this comment is

¹¹ SIA Regulation SHO Working Group; Stoecklein; and Vuksich.

¹² Stoecklein.

¹³ Vuksich.

¹⁴ SIA Regulation SHO Working Group.

¹⁵ Vuksich.

¹⁶ Stoecklein.

without merit. NASD believes that it is important to have the ability to address, through the exemptive process, situations that may warrant relief. NASD's 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.

One commenter asserts that a uniform short sale delivery requirement for non-reporting securities would be preferable.¹⁷ This commenter argues that, without a uniform standard, the proposal may lead to regulatory arbitrage. This commenter urges the Commission, as part of its review of the Regulation SHO pilot program, to amend the Regulation SHO delivery requirements to address non-reporting securities. NASD agrees that uniformity with respect to rulemaking across self-regulatory organizations ("SROs") is preferable, to the extent possible and practicable. If the SEC determines to amend the Regulation SHO delivery requirements to apply to non-reporting securities, NASD would consider repealing its rule. Although NASD believes that the vast majority of trading in non-reporting securities occurs through NASD members, NASD notes that uniformity in this area can be achieved if other SROs propose similar requirements. In any event, NASD does not believe it appropriate to forestall an SRO proposal solely because other SROs have not put forth comparable requirements.

One commenter indicates that NASD did not state, as part of its rule filing, that it had performed an analysis to determine the number of additional securities that would be captured under the proposal.¹⁸ The commenter indicates that such information would permit the industry to evaluate the impact of the proposal on their procedures and systems. This commenter requests that, if such analysis was performed, NASD make those results available.

As an initial matter, NASD notes 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 SEC's Regulation SHO adopting release. Specifically, the Regulation SHO adopting release noted that the SEC's Office of Economic Analysis analyzed National Securities Clearing Corporation 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.¹⁹ Under NASD's proposal, because these securities also would be subject to the additional dollar threshold requirement imposed on non-reporting securities, the estimated percentage of non-reporting threshold securities resulting from

¹⁷ SIA Regulation SHO Working Group.

¹⁸ SIA Regulation SHO Working Group.

¹⁹ See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (Footnote 86).

this proposal would be further reduced.²⁰ In any event, NASD recognizes that the proposed rule change may impose additional costs and burdens on member firms. NASD, however, has endeavored to minimize these burdens by imposing substantially similar requirements as already imposed by the Regulation SHO delivery requirements. By taking this approach, NASD's proposal would not change existing delivery requirements, but only expand the universe of securities to which such delivery requirements may apply.

One commenter also believes that the proposal may result in negative consequences, such as further reducing liquidity in illiquid securities and having a greater impact on price than would be the case with reporting securities.²¹ NASD notes that similar concerns were raised in the context of Regulation SHO, to which the SEC responded that the requirements will only apply to a limited number of securities and will not apply to any fails to deliver positions effected prior to the security meeting the threshold requirements. NASD believes these same assertions apply in this context as well, given the SEC's Office of Economic Analysis' estimates on non-reporting securities with fails to deliver of 10,000 shares or greater²² and that NASD's proposal would further reduce this estimate due to the proposed additional dollar threshold requirement.

Other commenters raise concerns regarding issues not germane to this filing, including the Regulation SHO locate requirements,²³ Depository Trust & Clearing Company and its stock loan program, and the continuous net settlement system.²⁴ For example, some commenters object to the bona-fide market making exception to the Regulation SHO requirement to locate securities available for borrowing, asserting that such exception is being abused and should be eliminated.²⁵ One commenter contends that the electronic clearing function should be decentralized with such authority residing instead with public company transfer agents, as well as decentralizing broker-dealer regulation to provide the regional exchanges with greater authority.²⁶ Because the changes recommended by these commenters are outside the scope of the proposed

²⁰ Moreover, 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. For this time period, the analysis indicated that 44 securities would be deemed non-reporting threshold securities under the proposed threshold requirements.

²¹ SIA Regulation SHO Working Group.

²² See infra note 10.

²³ Chepucavage.

²⁴ Vuksich, II and Stoecklein.

²⁵ O'Brien; Patch and Stoecklein.

²⁶ Vuksich, II.

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changes that are part of this rule filing or relate to changes that are beyond the purview of NASD, NASD is not responding to these recommendations specifically herein.

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NASD believes that the foregoing responds to the material issues raised by commenters to this rule filing. If you have any questions, please contact me at (202) 728-8156; email: andrea.orr@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

A handwritten signature in black ink, appearing to read "Andrea D. Orr". The signature is fluid and cursive, with a long horizontal stroke at the end.

Andrea D. Orr
Assistant General Counsel

cc: Victoria Crane (SEC)