



June 24, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Subject: File No. SR-NASD-2004-056

Dear Mr. Katz,

Introductory Summary Statement

Pink Sheets LLC ("Pink Sheets") strongly supports increased regulatory oversight over the trading of OTC Equity Securities. It is therefore with considerable reluctance that we submit this comment objecting to the time of implementation of the above-referenced Proposed Rule Change by the National Association of Securities Dealers, Inc. (the "NASD") Relating to Short-Sale ACT Reporting Requirements (the "Proposed Rule").

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, real-time quotation service for OTC equities and bonds for market makers and other registered broker-dealers. During the month of April 2004, registered broker-dealers used the services of Pink Sheets to electronically negotiate 359,515 trades in OTC equity securities consisting of 20,612,015,510 shares of stock with a market value of \$2,017,438,749.

On a related note, we are disturbed by the NASD's designation of the Proposed Rule as a mere "stated policy, practice or interpretation with respect to the meaning, administration, or enforcement of an existing rule." The Proposed Rule is an amendment to the existing rules governing transaction reporting for OTC Equity Securities contained in the NASD 6600 Rule Series. Moreover, it is a bald and unambiguous reversal of stated policy not fairly implied by the existing reporting requirements. Accordingly, it should have been designated as a proposed rule change filed pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the "Exchange Act") that would not be implemented until approved by the Securities and Exchange Commission (the "Commission") after interested persons were given an opportunity to submit written data, views and arguments concerning the Proposed Rule.

At a minimum, the use of the more deliberate process required by Exchange Act Sections 19(b)(1) and (2) would permit the NASD to avoid a grave regulatory mistake. Implementation of the Proposed Rule by market participants will require substantial systems changes for participants in the OTC market. Forcing such changes to take place in less than two months is reckless. There is a significant risk that such haste will lead to system failure with attendant unjustifiable market losses, all to the detriment of the investing public.

We therefore respectfully request that the Commission summarily abrogate the Proposed Rule in the public interest, for the protection of investors and in furtherance of the purposes of the Exchange Act. In the alternative, we request that the Commission suspend the operational effectiveness of the Proposed Rule until November 30, 2004.

Pink Sheets Objects to the Timing of the Proposed Rule, Not Its Substance

At the outset, we stress that Pink Sheets whole-heartedly supports the substantive requirements of the Proposed Rule. Pink Sheets believes that short-sale transactions should be reported through the Automated Confirmation Transaction Service (ACT), not just for National Market System securities, but also for exchange-listed, SmallCap, convertible debt, OTC Bulletin Board and OTC equity securities.

Pink Sheets objects solely to the time of implementation and the abuse of the rule making process. The Proposed Rule will be operationally effective on July 26, 2004. This simply does not allow sufficient time for prudent implementation of the complex system changes necessary to comply with its terms.

For example, to comply with the Proposed Rule, Pink Sheets will be required to re-program its OTC Dealer application, MDS server, internal messaging protocol, EMS server, FIX gateway and ACT reporting server. Each of these systems is essential to the operation of the services Pink Sheets offers to broker-dealers and, by extension, the investing public. The prudent procedure for implementing the required systems changes requires the following steps:

- First, each of these six systems must be re-programmed to install an ACT reporting module.
- Second, the new programming code must be audited in a quality assurance (QA) process. Any errors must be returned to the programmers for correction and rechecked in the QA process.
- Third, the re-programmed systems must be run on test servers using historical data for several days to emulate a real world environment. System instabilities

and collateral deficiencies that are identified during this process may require additional programming, which in turn, must be audited in QA and re-tested.

- Fourth, certain clients will be asked to participate in beta testing of the enhanced system. This process may identify other weaknesses in the re-programmed modules, which in turn, must be corrected, run through QA, tested on internal servers and then beta tested.
- Finally, the enhanced systems will be rolled out in stages, one module at a time, to the general client community. Staged rollouts are essential for prudent installation of a change of this magnitude because they permit the identification of any non-conforming module. Any non-conforming module can then be backed-out, reprogrammed and tested without causing a major systems crash on one or more client servers.

The process described above has proven necessary to reduce the probability of expensive system breakdowns, and their attendant negative consequences in the OTC marketplace and investor confidence. It is reckless to force reprogramming of this magnitude to be accomplished by July 26, 2004, because such haste foolishly creates unnecessary and drastic risks of system instability, downtime and market disruption.

While Pink Sheets strongly supports the substance of the Proposed Rule, and objects to the time of operational effectiveness, it should nonetheless be noted that there are no trading rules currently applicable to short sales of equity securities that are not part of the National Market System. So, the ACT reporting requirements imposed by the Proposed Rule are not based on any apparent regulatory objective, and nothing in the NASD's proposal suggests any regulatory purpose for such reporting. Moreover, we are not aware of any investor interest in such reporting.

On the other hand, Pink Sheets has received numerous requests from investors for short interest disclosure. At present, NASD Rule 3360 only requires reporting of short positions in NASDAQ and exchange-listed equities held by broker-dealers. There is no short interest disclosure for stocks traded on the OTC Bulletin Board[®] or Pink Sheets. Accordingly, we believe that, in addition to a change to the ACT reporting rules, it is far more important to investors to amend NASD Rule 3360 to require the prompt reporting and dissemination of short positions in all equity securities. The lack of transparency in short position reporting creates an opportunity for unscrupulous promoters and issuers to create false reports that short selling is the source of selling pressure in the OTC market place. This creates a misleading perception that the seller will need to return to the market to buy any shares that are for sale to cover the short position. Instead, it is often the case that sales are being made by disgruntled shareholders, and in egregious cases, an insider taking advantage of the confusion in the market place caused by a lack of good short interest information. **That is why Pink Sheets most common request from investors and the public is for short interest disclosure in OTC equity securities.**

There is simply no good reason to rush the implementation of the Proposed Rule, which achieves no apparent regulatory purpose and is not useful to investors, while at the same time depriving investors of short interest disclosure.

Pink Sheets estimates that approximately 180 days are required to accomplish the prudent re-programming and installations necessary to comply with the Proposed Rule using the process outlined above. We therefore urge the Commission to postpone the operational effectiveness of the Proposed Rule until November 30, 2004.

Pink Sheets Objects to the Immediate Effectiveness of the Proposed Rule

The NASD has designated the Proposed Rule as a “stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule” pursuant to Rule 19b-4(f)(1) under the Exchange Act. Rules filed by self-regulatory organizations, such as the NASD, pursuant to Rule 19b-4(f)(1) are effective immediately upon filing, thereby avoiding the pre-approval notice and comment procedure generally associated with rule changes. For the reasons set forth below, we believe the NASD’s designation of the Proposed Rule is incorrect and improper. Moreover, we believe that the changes required by the Proposed Rule forcefully demonstrate that this is a matter that deserves a full notice and comment procedure to avoid grave regulatory error.

Section 19(b)(1) of the Exchange Act generally requires self-regulatory organizations to file proposed rules with the Commission. The public must be provided with a notice of the proposed rule and the reasons for its proposed adoption, and interested persons are permitted to submit “written data, views, and arguments” concerning the proposed rule. No proposed rule may be approved by the Commission, except in accordance with this procedure.

This “notice and comment” procedure serves two vital regulatory objectives. First, in a representative democracy, where regulatory agencies are not subject to the direct electoral process, notice and comment serves to satisfy the minimum requirements of due process guaranteed by the U.S. Constitution. Second, the procedure also ensures that regulatory agencies will have access to the information required to avoid regulatory mistakes and failed policies.

Exchange Act Section 19(b)(3)(A) provides a limited exception to the notice and comment procedure where necessary for the adoption of proposed rules that constitute “a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization.” In such cases, the public was presumably given an opportunity to comment on the rule itself so that further pre-approval procedures may not be desirable or necessary. Exchange Act Rule 19b-

4(f)(1) under the Exchange Act, as described above, has been promulgated by the Commission pursuant to its authority under Section 19(b)(3)(A).

On the other hand, Exchange Act Rule 19b-4(d) provides that an interpretation of an existing rule by a self-regulatory organization shall be deemed a proposed rule change, and therefore not within the limited exception to the notice and comment procedure, if the interpretation, among other things, “is not reasonably and fairly implied by the rule.” The Proposed Rule is not, in fact, reasonably and fairly implied by the current ACT reporting rules and should not have been designated for immediate effectiveness under Exchange Act Rule 19b-4(f).

Over-the-counter transactions in most equity securities have been reportable in ACT since 1993, when the requirements for real-time reporting of NASDAQ securities were, for the first time, made applicable to other equity securities traded over-the-counter.¹ NASD Rule 6130 was therefore amended to provide that transactions reportable under the NASD Rule 6600 series would be reported through ACT. The NASD Rule 6600 series governs the reporting of OTC Equity Securities, a term that generally includes most equity securities traded over-the-counter, except NASDAQ, SmallCap, OTC Bulletin Board or exchange-listed securities.

It is important to note that while the 1993 amendments to NASD Rule 6130 provided that transactions in OTC Equity Securities would be reported through ACT, the Rule itself is primarily devoted to describing the substantive reports that will be made in NASDAQ securities. NASD Rule 6130(b) therefore states that “ACT Participants shall transmit trade reports to the system for transactions in *Nasdaq* securities within 90 seconds after execution” (emphasis added). NASD Rule 6130(d) lists the items that shall be reported for transactions in NASDAQ securities.

In contrast, the reportable items for OTC Equity Securities are found in NASD Rule 6620(c), which under the heading “Information to be Reported” provides the following list:

- (1) Symbol of the OTC Equity Security;
- (2) Number of shares;
- (3) Price of the transaction as required by paragraph (d) below; and
- (4) A symbol indicating whether the transaction is a buy, sell, or cross.

In 1994, in an effort to meet competitive pressures from the national securities exchanges, the NASD adopted a short sale rule for National Market System securities

¹ See “Order Approving Proposed Rule Change of the National Association of Securities Dealers, Inc., Relating to Establishment of Requirements for Real-Time Reporting of Members’ Over-the-Counter Transactions in Certain Equity Securities,” Release No. 34-32647 (July 22, 1993).

("NMS Securities").² In conjunction with the adoption of the short sale rule, NASD Rule 6130(d) was amended to include "short sale" and "short sale exempt" transaction indicators on reports for NASDAQ securities.

NASD Rule 6620(c), the rule governing reports for OTC Securities, was not amended in 1994. To this day, NASD Rule 6620(c) does not require any short sale indicators with respect to transactions in OTC Equity Securities.

We submit that the ACT transaction reporting rules were never intended to include securities that were not part of the National Market System. In the absence of a short sale rule, short sale transaction reporting serves no regulatory function in the marketplace. Accordingly, soon after its adoption and from time to time thereafter, the NASD notified its members that a short sale indicator would not be required on transactions involving non-NMS securities.

For example, on April 2, 1997, in Head Trader Alert No 31-40, attached as Exhibit A, market makers were flatly instructed in NASDAQ's publicly available NASDAQTrader website that the ACT reporting requirement did not apply to non-NMS Securities:

"The new ACT reporting requirements only apply to NASDAQ securities that are subject to the NASD's short sale rule." (emphasis added)

It is specious to maintain, as the NASD does in its statement of the purpose of the proposed rule change, that the Proposed Rule merely "clarifies" an ambiguity. On the contrary, the NASD has, until now, repeatedly affirmed that the ACT short sale reporting requirements apply only to NASDAQ securities subject to the NASD's short sale rule. Far from ambiguous, the NASD's position was crystal clear – the ACT short sale reporting rules only applied to NMS Securities.

The Proposed Rule cannot be reasonably and fairly implied by the current ACT reporting rules. The Proposed Rule is an amendment to the reporting rules governing OTC Equity Securities contained in NASD Rule 6620(c). Nothing in NASD Rule 6620(c) implies in any way that a short sale indicator is required in reports of transactions in OTC Equity Securities. Instead, the NASD has bootstrapped the reporting requirements for transactions in NASDAQ Securities contained in NASD Rule 6130(d) onto transactions governed by NASD Rule 6620(c), thereby bulldozing down an entire series of rules adopted through a formal notice and comment procedure. The NASD's rulemaking procedure in this case violates the letter and the spirit of Exchange Act Section 19(b).

Moreover, the Proposed Rule is a *reversal* of the NASD's long-standing interpretation of the ACT reporting rules, an interpretation that follows ineluctably from the logic of

² See "Short Sale Rule Approval Order," Release No. 34277 (July 7, 1994).

NASD's short sale rule and has been emphasized repeatedly in public statements. It follows that the NASD's submission of the Proposed Rule under Exchange Act Rule 19b-4(f)(1), as a mere clarification of an existing rule, was misleading and improper.

Relying on the NASD's consistent and unambiguous position, Pink Sheets' systems, in common with many other current industry systems used for ACT transaction reporting, must undergo substantial modifications to conform to the new rule. This would not be necessary if, as the NASD disingenuously maintains, the Proposed Rule is merely a clarification, as compared to a reversal, of regulatory policy.

By forcing changes to be made in complex systems on a "fast track," the NASD is flying in the face of reason, exactly the sort of dangerous regulation by fiat that Section 19(b) of the Exchange Act was intended to preclude. It denies interested persons their Constitutional due process opportunity to submit written data, views and arguments. Pink Sheets made an effort to communicate with the NASD orally regarding the implementation of the Proposed Rule, but has not received a fair hearing. To the best of our knowledge, the NASD has not made any effort to determine from its members or any other reliable source whether or not it is feasible to require implementation of the Proposed Rule on July 26, 2004.

As is often the case when rules are enacted without good information, the timing of operational effectiveness of the Proposed Rule is a regulatory mistake. Pink Sheets and other industry participants need time to make the required changes in a prudent manner. Failure to allow an appropriate amount of time to make these changes poses unjustifiable risks of systems failure and market disruption. No valid regulatory objective is served by hastening the implementation of this reporting requirement, and time-pressured implementation threatens the interests of the investing public. The NASD did not contact Pink Sheets nor to our knowledge any of their member firms or electronic order processing vendors to ascertain the needed systems and business process changes needed to comply with the Proposed Rule.

Exchange Act Section 19(b)(3)(C) provides that the Commission may abrogate the change in the rules of a self-regulatory organization made in reliance on Exchange Act Section 19(b)(3)(A), and require the proposed rule change to be refiled for public comment in accordance with the provisions of Exchange Act Section 19(b)(2), if it appears that such action is necessary or appropriate in the public interest, for the protection of investors or otherwise. We respectfully submit that abrogation of the Proposed Rule is in the public interest and is essential to protect investors from unjustifiable systems breakdown and market disruption.

Request for Commission Action

We therefore respectfully request that the Commission summarily abrogate the Proposed Rule in the public interest, for the protection of investors and in furtherance of



Mr. Jonathan G. Katz

the purposes of the Exchange Act and require the NASD to refile the Proposed Rule for notice and comment in accordance with the provisions of Exchange Act Section 19(b)(2), supplementing the current Rule Proposal with the required amendments to Rule 6620(c) as well as proposing the changes required to expand Rule 3360 to all equity securities. In the alternative, we request that the Commission suspend the operational effectiveness of the Proposed Rule until November 30, 2004 to permit the prudent and safe reprogramming of industry systems.

Please call me if you have any questions.

Very truly yours,

R. Cromwell Coulson
Chief Executive Officer