

August 24, 2005

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

**Re: Release No. 34-52131; File No. SR-NASD-2005-093 –
Rule Change Relating to Amendments to NASD Rule 3370**

Dear Mr. Katz:

The Securities Industry Association (“SIA”)¹ appreciates the opportunity to respond to the above-referenced rule filing, which re-adopts as new NASD Rule 3370 (“Rule 3370”) the provisions of former NASD Rule 3370(b) (“Former Rule 3370” or “Former Rule”) with a number of significant modifications.² Specifically, Rule 3370 requires member firms to make, and document on the order ticket, certain affirmative determinations relating to the location of securities sold long. NASD designated the rule filing as “non-controversial” under Rule 19b-4(f)(6) of the Securities Exchange Act of 1934 (the “Exchange Act”),³ which rendered the rule change effective upon receipt of the filing by the Securities and Exchange Commission (the “Commission” or “SEC”).

SIA respectfully objects to the designation of this rule filing as “non-controversial” on the grounds that Rule 3370 eliminates two important exemptions from the order-ticket marking requirements, is broadened to cover long sales of securities for the account of non-NASD member broker-dealers, and conflicts with regulation of long-

¹ The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

² Securities Exchange Act Rel. No. 52,131 (July 27, 2005), 70 Fed. Reg. 44,707 (Aug. 3, 2005) (the “Re-Adopting Release”).

³ 17 CFR 240.19b-4(b)(6).

sale order-ticket marking requirements recently adopted by the Commission. Accordingly, SIA respectfully requests that the Commission exercise its authority under Section 19(b)(3)(C) of the Exchange Act to summarily abrogate new Rule 3370. Moreover, to the extent the NASD elects to resubmit this proposed change, SIA believes that it should do so pursuant to the notice-and-comment process generally required by Section 19(b) of the Exchange Act.

I. Background and Rule Summary

On July 28, 2004, the SEC adopted Regulation SHO under the Exchange Act in order to modify and replace certain existing SEC and self-regulatory organization ("SRO") rules governing activities associated with the sale of equity securities.⁴ Among the intended benefits of Regulation SHO was the implementation of uniform standards that further the "goals of regulatory simplification and avoidance of regulatory arbitrage."⁵ To that end, Regulation SHO provides a comprehensive regulatory framework for long and short sales, including rules applicable to the acceptance of long and short sale orders, marking of order tickets, delivery of borrowed shares and buy-ins.

Pursuant to SEC Rule 200(g), an order can be marked "long" only when the seller owns the security being sold and the security either is in the physical possession or control of the broker-dealer or it is reasonably expected that the security will be in the physical possession or control of the broker-dealer no later than settlement date. Regulation SHO's long sale order-ticket marking provision establishes a standard that a broker-dealer must satisfy without either (i) mandating a specific order-by-order determination regarding the present location of the securities to be sold and whether they will be delivered by settlement date or (ii) imposing an obligation to record the determination on the order ticket.

In light of the adoption of Regulation SHO, NASD subsequently repealed several of its rules, including the Former Rule, on the basis that they were duplicative of or overlapped with the uniform requirements of Regulation SHO.⁶

As noted in the Re-Adopting Release, NASD now seeks to reinstate the affirmative determination requirements previously contained within Former Rule 3370(b)(1) and clarify members' obligations with respect to customer long sales.⁷ As

⁴ Securities Exchange Act Rel. No. 50,103 (July 28, 2004), 69 Fed. Reg. 48,008 (Aug. 6, 2004) ("Regulation SHO Adopting Release").

⁵ Regulation SHO Adopting Release at 48,025.

⁶ Securities Exchange Act Rel. No. 50,822 (Dec. 8, 2004), 69 Fed. Reg. 74,554 (Dec. 14, 2004). NASD notes in the Re-Adopting Release at n. 6 that the deletion of its affirmative determination requirements in connection with adoption of Regulation SHO was unintentional.

⁷ NASD states that the new Rule 3370 is intended simply to reinstate the prior affirmative determination requirements that had been inadvertently omitted by the NASD in its prior rule filing repealing Former Rule 3370.

adopted, however, Rule 3370 differs substantially from the Former Rule. Specifically, Rule 3370 now imposes the order-ticket marking requirements of Former Rule 3370(b)(4)(A) on long sales of securities held at another broker-dealer or bank, sales of securities held long in the customer's account with the member but which are not in the possession or control of the member, and long sales of securities for non-NASD member broker-dealers.

II. SIA's Comments on Rule 3370

While SIA appreciates the NASD's efforts to reduce mis-marked long sale orders and fails to deliver on long sales, SIA respectfully objects to the submission of the rule change as "non-controversial" on the grounds that Rule 3370 does more than merely restore and clarify the affirmative determination requirements previously repealed as part of the NASD's efforts to conform its rules to Regulation SHO. Rather, the current iteration of the rule materially differs from the prior version in that it fails to maintain critical exemptions found in Former Rule 3370(b). As such, Rule 3370 imposes new order-ticket marking requirements for securities held on deposit at another broker-dealer or bank, potentially creates added costs and administrative burdens for member firms (many of whom have already expended significant resources aimed at compliance with Regulation SHO), and potentially hinders execution quality and market liquidity. Accordingly, SIA believes that Rule 3370 should be abrogated and, if re-filed, subject to the public notice and comment process so that member firms, and the public generally, may be given an opportunity to express their views on the rule.

As the SEC is aware, Rule 19b-4(f)(6) was adopted in 1994 to help expedite and streamline the process by which SROs can implement certain non-controversial rule changes that would not elicit adverse comments or require the degree of review appropriate for more controversial filings, such as those that may implicate basic policy considerations.⁸ Insofar as the underlying impetus for Rule 3370 is directly related to the significant rule change initiatives of Regulation SHO (many interpretive details of which are still being worked out with the SEC staff), and based on the exclusion of certain language previously contained within Former Rule 3370, SIA is concerned that permitting the NASD to unilaterally re-adopt this rule would reintroduce the potential for conflicting standards among SROs -- an outcome clearly at odds with the stated objective of Regulation SHO.

A. Rule 3370 Imposes New Obligations on Member Firms

Former Rule 3370 did not impose any specific order-ticket marking or documentation requirement prior to acceptance or execution of long sales if: (i) the member had possession of the security, (ii) the customer was long in his account with the

⁸ Exchange Act Rel. No. 34,140 (June 1, 1994); 59 Fed. Reg. 29,393 (June 7, 1994) (giving two examples of SRO rule changes considered non-controversial: where an SRO adds an existing rule to its Minor Rule Violation Plan; or where an SRO permits its members to transmit certain data to the SRO via electronic means).

member, or (iii) the security was on deposit in good deliverable form with another broker-dealer or a bank and instructions were given to that bank or broker to deliver the securities against payment. Only if none of the three conditions above existed did Former Rule 3370 require a member firm to record on the order ticket the communication with the customer regarding the present location of the securities and whether they would be delivered by settlement date.⁹

By contrast, Rule 3370, as reinstated, provides that to the extent a member or associated person does not have physical possession or control of the securities, the member must document, at the time the order is accepted, the communication with the customer as to the present location of the securities in question, whether they are in good deliverable form, and the customer's ability to deliver them to the member by settlement date. The new rule re-adopts Former NASD Rule 3370(b)(1)(A) and subjects all other orders to the order-ticket marking requirement, including orders to sell securities on deposit with another broker-dealer or bank and securities carried long in the customer's account with the member but which are not in the possession or control of the member. In SIA's view, these constitute significant changes to the Former Rule and are not fairly characterized as "clarifications." Most sales of securities for institutional customers involve the sale of securities on deposit with another broker-dealer (*i.e.*, the customer's prime broker) or bank (*i.e.*, the customer's custodian). These arrangements enable customers to execute transactions with a variety of broker-dealers without interfering with existing credit or custodial relationships. Moreover, the re-adopted Rule 3370 requires a member firm to record the same communication on order tickets where a customer seeks to sell a security carried long in the customer's account but which is not in the possession or control of the member.

Former Rule 3370(b)(1) was also limited to customer long sales. As reinstated, Rule 3370 applies to long sales of securities by both customers and non-NASD member broker-dealers. Regulation SHO's order-ticket marking requirements, by contrast, are uniform, without distinguishing between NASD and non-NASD member firms.

B. Rule 3370 Will Adversely Impact Member Firms' DVP Business

Because institutional business is predominantly handled on a delivery-versus-payment ("DVP") basis, Rule 3370 will now require firms to make and document the affirmative determination, prior to execution, on virtually all long sale orders placed on behalf of institutional accounts on a DVP basis. This will include sales effected on behalf of registered investment companies that custody their securities at third-party banks, as well as other accounts that custody their securities at one or more prime brokers, but trade through many executing brokers.

⁹ Former Rule 3370(b)(4)(A) only required member firms to satisfy the affirmative determination requirement contained in Former Rule 3370(b)(1)(C) by detailing on the order ticket the conversation with the customer as to the present location of the securities and whether they would be delivered in good deliverable form by settlement date.

To require firms to establish a process to obtain and document the information required in Rule 3370 at the point of order entry goes well beyond the information that was typically obtained at that stage of the order handling process under the Former Rule 3370 for such accounts. In addition to imposing administrative burdens on member firms, Rule 3370 will introduce significant delays or otherwise impede the ability of member firms to handle long sale orders for institutional accounts in a quick and efficient manner, thus potentially compromising a firm's ability to obtain best execution on behalf of its customers.

The affirmative determination requirements also pose a problem for the ever-growing universe of orders delivered to brokers by their customers electronically. Typically, the message protocols for order delivery are not structured to support settlement location and delivery instructions. That information is almost universally handled in the back office processes each evening or in subsequent days leading up to settlement, and is generally based on standing instructions as to the location from/to which funds and securities are to be delivered, as opposed to any order-by-order references to that information at the front end of the order entry process.

By requiring an affirmative determination in connection with each individual order, Rule 3370 may substantially delay execution of such orders and may discourage customers from separating the execution and custodial functions at a time when best execution standards are evolving in the opposite direction. SIA does not believe that the benefit to be derived from imposing communication and order-ticket marking requirements on an order-by-order basis will outweigh the Rule's negative impact on execution efficiency.

C. New Rule 3370 will Negatively Impact Member Firms' Margin Trading

SIA also is concerned about the practical difficulties associated with the application of affirmative determination requirements to sales of securities held in a margin account that have been rehypothecated pursuant to a margin account agreement, and therefore are outside of the broker's "physical possession or control." Under such circumstances, we believe that compliance with the affirmative determination requirements -- namely, an order-by-order customer representation as to the present location of the securities -- will be extremely difficult, if not impossible, thereby negatively impacting market liquidity and broker-dealer funding.

Broker-dealers' use of customer margin securities represents an important source of broker-dealer funding and securities market liquidity. Traditionally, upon signing a margin account agreement, a customer authorizes his or her broker-dealer to re-pledge or rehypothecate securities with a market value equal to 140% of the net debit in the customer's margin account.¹⁰ Broker-dealers rely on this authorization to use customer securities in the ordinary course of business, such as to satisfy delivery obligations of

¹⁰ See 17 C.F.R. §§ 240.15c3-3.

other customers or the firm's proprietary short sales, to fund customers' margin debit balances, or to lend to other market participants.

Rule 3370 is impractical with respect to sales of securities carried long in the client's account with the member but not in the member's possession or control. The client simply cannot make a representation as to the location of the securities. Indeed, in many instances, the client is unaware that his or her securities have been rehypothecated since the account statements continue to show the rehypothecated margin securities as long positions held in the account. Indeed, it is our understanding that most firms similarly have no way of knowing on a real-time basis whether a particular customer's securities held in a margin account are, or are not, in that firm's possession or control. For example, many firms review account activity on a one-day lag basis using systems to determine what securities are within the broker's possession or control. Since such systems do not distinguish on a client-by-client basis whose shares are in the box and whose have been rehypothecated, neither the customer nor the firm knows on a real-time basis whether the firm is in possession of a particular customer's margin securities.¹¹

D. New Rule 3370 Differentiates Between NASD and Non-NASD Member Broker-Dealers

Rule 3370 requires member firms to comply with the affirmative determination requirements on an order-by-order basis even with respect to orders from other broker-dealers that are not members of the NASD. Former NASD Rule 3370(b)(1) was limited to customer long sales. SIA believes that this provision is unnecessary. Every broker-dealer is subject to Regulation SHO and subject to the same requirements regarding the proper marking of its own orders as long, short or short-exempt. The imposition by NASD of different order-ticket marking requirements on non-NASD member firms highlights the risk of permitting the SROs to begin again the process of adopting differing regulations relating to the marking and handling of long and short sales.

E. Rule 3370 Is Inconsistent with the Exchange Act

Section 19(b)(3)(C) specifies that the Commission summarily may abrogate any proposed SRO rule change which has taken effect upon filing pursuant to section 19(b)(3)(A) if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. As noted above, Regulation SHO requires that, with respect to all long sales, firms must have a reasonable expectation that the seller will deliver the security by settlement date (no documentation requirement is specified). The Commission imposed the "locate" requirement of Rule 203(b), which requires documentation, only on short sales. The Commission's election to apply a record-keeping requirement in connection with the acceptance of short sales under Regulation

¹¹ We further note that SIA has had, and continues to have, extensive discussion with the SEC staff regarding the practical issues associated with Regulation SHO's requirements, in particular Rule 203(a) and 200(g), in relation to long sales of margin securities that have been rehypothecated pursuant to the customer's margin agreement.

SHO, but not long sales where the broker had a reasonable expectation that the security would be delivered by settlement date, constituted the decision of the Commission. Therefore, the provisions of Former Rule 3370 -- even those relating to long sales -- were supplanted by the adoption of Regulation SHO, and not inadvertently deleted by the NASD.

III. Conclusion

In conclusion, SIA respectfully urges the SEC to exercise its authority under Section 19(b)(3) of the Exchange Act to summarily abrogate Rule 3370. We thank you for the opportunity to provide comments on this rule change. If you have any questions, please contact the undersigned at (202) 216-2000, Amal Aly, SIA Vice President and Associate General Counsel, at (212) 608-1500, or Ann Vlcek, SIA Vice President and Associate General Counsel, at (202) 216-2000.

Sincerely,



Ira D. Hammerman
SIA Senior Vice President and
General Counsel

cc: The Hon. Christopher Cox, Chairman
The Hon. Cynthia Glassman, Commissioner
The Hon. Paul Atkins, Commissioner
The Hon. Roel Campos, Commissioner
The Hon. Annette Nazareth, Commissioner
Giovanni Prezioso, General Counsel
Robert L.D. Colby, Deputy Director, Division of Market Regulation
Lawrence E. Bergmann, Associate Director, Division of Market Regulation
James A. Brigagliano, Assistant Director, Division of Market Regulation
Josephine Tao, Branch Chief, Division of Market Regulation
Julian Rainero, Bingham McCutchen LLP