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August 24, 2005

Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

Re: File No. SR-NASD-2005-093

Mr. Katz:

On behalf of Bear, Stearns & Co. Inc., BNY Brokerage Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Pershing LLC, SunTrust Capital Markets, Inc. and UBS Securities LLC, we submit these comments in response to the above-referenced rule filing by the National Association of Securities Dealers Inc. ("NASD"), which was declared immediately effective by the U.S. Securities and Exchange Commission ("SEC" or the "Commission") on July 27, 2005.[1] We respectfully request that the Commission exercise its authority under section 19(b)(3)(C) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), to summarily abrogate the re-adopted NASD rule 3370 and, should the NASD elect to re-propose the rule, require that it be re-proposed in accordance with the provisions of Exchange Act section 19(b)(1) and reviewed in accordance with Exchange Act section 19(b)(2).

I. Background

On July 28, 2004, the Commission adopted Regulation SHO to provide a new regulatory framework governing the sale of equity securities, effective January 3, 2005.[2] Regulation SHO effected significant changes in the regulation of long and short sales, including rules relating to: the determination of net long/short

[1] Securities Exchange Act Release No. 52131 (July 27, 2005), 70 Fed. Reg. 44707 (August 3, 2005) (the "Re-Adopting Release").

[2] Securities Exchange Act Release No. 50103 (July 28, 2004), 69 Fed. Reg. 48008 (August 6, 2004) (the "Regulation SHO Adopting Release").

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positions; the standards for acceptance of long and short sale orders; the marking of long and short sale order tickets; the handling of failures to deliver and buy-ins. One of the intended benefits of Regulation SHO was the implementation of a uniform regulatory standard, including the standards and requirements applicable to the acceptance of long and short orders and associated record-keeping requirements. The Commission expressly stated in the Regulation SHO Adopting Release that "Rule 203 [governing the borrowing and delivery requirements on long and short sales] supplants ... overlapping SRO rules,"[3] and the Commission noted that most commenters on the Regulation SHO proposal welcomed the replacement of disparate SRO requirements.[4] The Commission noted that one of the benefits of a uniform locate requirement was the furtherance of "the goals of regulatory simplification and avoidance of regulatory arbitrage."[5]

Prior to the adoption of Regulation SHO by the Commission, former NASD rule 3370(b) imposed certain obligations on NASD member firms when accepting sale orders, whether long or short. Former rule 3370(b) was designed to ensure that a member could either borrow securities for delivery on a short sale or would receive securities from its customer no later than settlement date. Since Regulation SHO established specific requirements relating to broker-dealers' acceptance of both long and short sale orders, including when sell orders may be deemed long or short, when order tickets may be marked long or short, and what, if any, documentation requirements apply, it was widely understood and expected that former rule 3370(b) would be replaced in its entirety by Regulation SHO.

II. Elimination and Re-Adoption of NASD Rule

On November 30, 2004, consistent with the Commission's statements in the Regulation SHO Adopting Release, the NASD submitted a proposal to repeal former rule 3370(b) effective as of the Regulation SHO implementation date, January 3, 2005. Thus, as NASD members were expending a significant amount of resources aimed at compliance with Regulation SHO, they were advised that they no longer needed to comply with former rule 3370(b)(1).

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[3] Regulation SHO Adopting Release, 69 Fed. Reg. 48014.

[4] Regulation SHO Adopting Release, 69 Fed. Reg. 48013-14 at footnote 53.

[5] Regulation SHO Adopting Release, 69 Fed. Reg. 48025.

Now, however, the NASD has re-adopted rule 3370(b) as it related to long sales and eliminated significant exemptions contained in the old rule 3370(b)(1). The new rule 3370 was effective upon filing on July 27, 2005.[6] In the Re-Adopting Release, the NASD states that it is re-adopting rule 3370(b)(1) because it was inadvertently repealed when the provisions relating explicitly to short sales were repealed and notes that new rule 3370(b) has been re-worded for the purpose of "clarifying" the old rule.

New rule 3370(b) now states:

> "To the extent a member or person associated with a member does not have physical possession or control of the securities, the member or person associated with a member must document, at the time the order is taken, 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."

New rule 3370(b) is not a mere re-adoption and clarification of the prior rule as it related to long sales. New rule 3370(b) creates a significant documentation requirement in respect of orders that were previously exempt from any documentation requirement, including orders to sell long (i) securities that are on deposit with a bank or another broker-dealer, (ii) securities that have been hypothecated by the member and (iii) securities for the account of a non-NASD member broker-dealer.

III. The "Clarification" of 3370

Former rule 3370(b)(1)(A) through (D) prohibited member firms from accepting a long sale order unless: (A) the member had possession of the security, (B) the customer was long in his account with the member, (C) the member or associated person made an affirmative determination that the customer owned the security and would deliver it in good deliverable form by settlement date, or (D) 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.

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[6] *See*, the Re-Adopting Release.

Former rule 3370(b)(4)(A) stated that to satisfy the affirmative determination requirement contained in former rule 3370(b)(1)(C), the NASD member or associated person had to detail on the order ticket the conversation with the customer as to the present location of the securities and whether they were in good deliverable form permitting for delivery to the member within three days. By citing specifically to former rule 3370(b)(1)(C), former rule 3370(b)(4)(A) made clear that there was no order-ticket marking requirement if the member relied on (A), (B) or (D) in accepting a long sale order.

A. DVP Transactions

New rule 3370(b) imposes a new order-ticket marking requirement where the security is on deposit with a bank or another broker-dealer. This is no mere clarification. Omitting the exception formerly available under subparagraph (D) is a crucial omission because most institutional customers employ either an agent bank or prime broker to custody their securities while directing sell orders to a wide variety of executing broker-dealers.

New rule 3370(b) imposes an entirely new requirement that broker-dealers record on the order ticket the location of the securities, whether they are in good deliverable form and the customer's ability to deliver them to the member by settlement date. Both under former rule 3370 and currently, under Regulation SHO, it appeared appropriate for member firms to accept long sales of securities by institutions on the basis of a reasonable belief that the securities were on deposit with the customer's agent bank or prime broker and that the customer would deliver the securities in good deliverable form by settlement date, unless there exists a reason to believe otherwise (such as a pattern of fails).

B. Hypothecated Securities

New rule 3370(b) also eliminates the language in old rule 3370(b)(1)(B), which permitted a member firm to accept a long sale if the customer was long in its account with the member. Broker-dealers routinely borrow and re-lend customers' margin securities, as permitted by Exchange Act section 15c3-3 and authorized by the customer margin-account agreement. Rehypothecation enables broker-dealers to fund customer margin debits, make delivery in respect of other customers' short sales and lend securities to other market participants. Rehypothecated securities are not considered to be in a broker-dealer's possession or control. Under the former rule 3370(b), a broker-dealer could accept a customer's order to sell securities carried long for that customer's account, without recording on the order ticket the location of the securities. New rule 3370 eliminates this provision. As a practical matter, a customer would not be in a position to inform its broker-dealer as to the precise physical location of its

securities or whether they would be (re)delivered by settlement date. Customers generally are not aware which, if any, of their securities have been hypothecated. We assume it was not the intention of the NASD when clarifying the old rule 3370(b)(1) to omit this necessary provision.

C. Application to Non-NASD Member Firms

As reinstated, rule 3370 also imposes an entirely new requirement with respect to long sale orders from non-NASD member broker-dealers. Former NASD rule 3370(b)(1) was limited to customer long sales. New rule 3370 applies to long sales from both customers and non-NASD member broker-dealers. It is unclear why the NASD believed that this change was necessary, given that non-NASD member broker-dealers registered with the Commission are subject to Regulation SHO. Such broker-dealers would therefore already be under an obligation to properly mark their sales orders. Expansion of rule 3370 to cover long sales by non-NASD member broker-dealers raises the same concerns expressed by the Commission in Regulation SHO regarding differing SRO regulatory schemes that govern the handling of long and short sale orders. Regulations SHO's order-ticket marking requirements, by contrast, are uniform, without distinguishing between NASD and non-NASD member firms.

We note also that when, in 2004, the NASD amended rule 3370(b)(2) to require member firms to make an affirmative determination with respect to short sale orders from non-NASD member broker-dealers, the NASD submitted the proposed rule pursuant to Exchange Act section 19(b)(1) and member firms and the public were provided notice and an opportunity to comment.[7] Indeed, the rule turned out to be sufficiently burdensome that the date for compliance was extended to April 1, 2004.[8] The NASD stated that the reason for extending the compliance date was that "...some members need[ed] to make significant technological changes to their systems to comply with the new requirements..."[9] In many cases, these changes would similarly be required upon expansion of the former rule to long sale orders from non-NASD member firms.

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[7] Securities Exchange Act Release No. 48788 (Nov. 14, 2003); 68 Fed. Reg. 65978 (Nov. 24, 2003).

[8] Securities Exchange Act Release No. 49285 (February 19 2004); 69 Fed. Reg. 8717-01 (Feb 25, 2005).

[9] NASD Notice to Members 04-08.

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III. Abrogation is Appropriate and Necessary

We respectfully request that the Commission exercise its authority under Exchange Act section 19(b)(3)(C), to summarily abrogate the new rule 3370 and, should the NASD elect to re-propose the rule, require that it be re-proposed in accordance with the provisions of Exchange Act section 19(b)(1) and reviewed in accordance with Exchange Act section 19(b)(2).

A. Abrogation Standard

Believing new rule 3370(b) was "non-controversial," NASD submitted the rule filing in accordance with Exchange Act section 19(b)(3)(A) and rule 19b-4(f)(6) thereunder, which permits a proposed SRO rule change to take effect upon filing under certain circumstances.[10] 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) at any time within sixty days of the date of filing of such proposed rule change and require that the proposed rule change be re-filed in accordance with section 19(b)(1) and reviewed in accordance with the provisions of section 19(b)(2) 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. New rule 3370 was filed on July 27, 2005, and as a result, the Commission may abrogate the rule at any time before September 23, 2005.

We believe that abrogation of the rule is in furtherance of the goals of the Exchange Act and that the procedures provided by Exchange Act section 19(b)(2) will provide a more appropriate mechanism for determining whether either the former or the new rule 3370(b) is consistent with the Act. For the reasons set forth in the following sections, we believe there are serious questions whether new rule 3370(b), or even, given the passage of Regulation SHO, former rule 3370(b), is consistent with the Exchange Act.

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[10] Where the rule change: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) by its terms, does not become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest.

B. Significant Change to the Former Rule Requires Abrogation

New 3370(b) imposes significant new time and cost burdens on broker-dealers, and therefore should be subject to the usual notice-and-comment process. For example, the new NASD rule effectively requires member firms, when acting as executing broker, to make notations on order tickets -- notations that a member firm's order management system may not be capable of accepting or recording without significant programming changes requiring the expenditure of substantial time and resources. Moreover, with the prevalence of direct market access, member firms would be required to implement systems changes to ensure that a customer entered additional information before the order could be submitted for execution, a task of questionable regulatory benefit.

C. Abrogation Appropriate Even without Change in Former Rule 3370

We believe that the NASD's elimination of 3370(b)(1), even if not intentional, was appropriate and consistent with the implementation of Regulation SHO, which supplanted the need for SRO rules in this area. As a result, we believe that even if the NASD had sought to re-adopt former rule 3370(b)(1) in exactly the same form as the original version, such a measure would still be controversial and warrant formal notice and comment rulemaking in accordance with Exchange Act sections 19(b)(1) and 19(b)(2). As a result, we respectfully suggest that even if the NASD were to re-file former rule 3370(b)(1), without the three material changes discussed above, it should be done pursuant to the notice-and-comment process.

1. Former 3370(b)(1) Conflicts with Regulation SHO

Regulation SHO establishes the standards that broker-dealers must apply when accepting long and short sale orders, yet only with respect to short sales does Regulation SHO dictate a specific record-keeping requirement to evidence proper application of the standards. Regulation SHO dictates when a person is long,[11] when an order may be marked long,[12] and provides protective measures designed to ensure that orders marked long were in fact properly marked long.[13] The

[11] *See*, rule 200(a) through (f).

[12] *See*, rule 200(g)(1).

[13] *See*, rule 203(a)(1).

reinstatement of the NASD's requirement to document a "locate" for long sales clearly imposes an obligation not imposed by Regulation SHO, even though the Commission could have adopted such a requirement and elected not to do so.

Regulation SHO requires that, with respect to all long sales, firms must have a reasonable basis to believe delivery will be made on time by settlement date. No documentation requirement is specified. However, under the "locate" requirement of rule 203(b), broker-dealers must document the basis for their belief that delivery can be made on short sales.

The "locate" requirement of Regulation SHO was based largely upon NASD's affirmative determination requirement as specified in former rule 3370. Former rule 3370 imposed an affirmative determination requirement both with respect to long and short sales, yet the Commission chose only to apply a record-keeping requirement in connection with the acceptance of short sales under the Regulation SHO locate requirement contained in rule 203(b). Rather than require documentation to help ensure delivery on long sales, Regulation SHO addresses the issue of ensuring that orders accepted as "long" are actually long through rule 203(a), which prohibits broker-dealers from loaning or arranging for the loan of securities to effect delivery on long sales, except as specifically permitted.

That Regulation SHO does not contain identical provisions to an SRO rule dealing with the acceptance of long and short sales, does not mean that such SRO rule has not been supplanted. Former 3370(b)(1) is inconsistent with the requirements set forth in Regulation SHO and it should remain repealed. There is no compelling evidence of a need to reinstitute former rule 3370(b)(1). If the Commission were to determine rule 203(a) is not an effective measure against broker-dealers inappropriately accepting long sales, then the Commission might consider further protective measures through amendments to Regulation SHO, the regulation that deals with all aspects of the acceptance, marking, and delivery requirements regarding long and short sales.

2. Benefit of Regulatory Uniformity and Elimination of Regulatory Arbitrage

Regulation SHO was intended to provide continuity among the securities markets. As noted above, one of the intended benefits of Regulation SHO is the implementation of uniform regulatory standards and accompanying simplification and the avoidance of regulatory arbitrage." To permit the NASD independently to impose measures regarding the acceptance of long sales that are not required by the Commission or other SROs defeats one of the bases for Regulation SHO, and we therefore assert that the re-adoption of NASD rule 3370, in either old or new form, is inconsistent with the purposes of the Exchange Act.

3. Fairness

Finally, abrogation is necessary as a matter of basic fairness. As the Commission is aware, Regulation SHO imposed new and significant compliance obligations on broker-dealers. The adoption and implementation of Regulation SHO has been a lengthy and costly process for the securities industry, including myriad practical issues and interpretive questions. Further, the obligations incumbent upon broker-dealers by virtue of Regulation SHO are not yet complete when considering that the current pilot program is due to expire in 2006, likely resulting in further regulatory changes concerning short sales.

As early as the adoption of Regulation SHO in July 2004, NASD members have been focusing their efforts on complying with Regulation SHO rather than NASD rule 3370. Now, fully one year after the approval of Regulation SHO and its apparent nullification of former Rule 3370(b), and eight months after NASD repealed the rule as having been supplanted by Regulation SHO, NASD members have been informed that they face additional burdens when accepting long sale orders.

Conclusion

We appreciate the opportunity to comment on NASD rule 3370(b) and encourage the Commission both to abrogate the rule and reject any re-proposed rule 3370(b).

Sincerely,

Julian Rainero

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

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