

be made on settlement date.³⁷ These provisions apply to all NYSE member organizations, whether effecting transactions in exchange-listed securities on the NYSE, another national securities exchange, or in the over-the-counter market. Exceptions from the rule are provided for short sales by specialists, market makers, and odd lot dealers in fulfilling their market responsibilities.³⁸

The comparable NASD Rule 3370 generally provides that no member, or person associated with a member, shall effect a short sale for a customer or for its own account unless the member makes an "affirmative determination" that the member can borrow the securities or otherwise provide for delivery of the securities by settlement date.³⁹ The affirmative determination must be annotated in writing, evidencing that the member firm will receive delivery of the security from the customer or, if the member firm locates the stock, the identity of the individual and firm contacted who offered assurance that the shares would be delivered or were available for borrowing.⁴⁰ This requirement applies regardless of how a short sale order is

received, e.g., by the telephone, an electronic transmission, the Internet, or otherwise.⁴¹ This requirement does not apply to transactions in corporate debt securities, to bona fide market making transactions by Nasdaq market makers,⁴² or to transactions that result in fully hedged or arbitrated positions.⁴³

The NASD has also adopted several rules addressing failures to deliver. NASD Rule 3210 prevents a member, or person associated with a member, from selling a security for his own account, or buying a security as a broker for a customer if, with respect to domestic securities,⁴⁴ he has a fail to deliver in that security that is 60 days or older. NASD Rule 11830 imposes a mandatory close-out requirement for Nasdaq securities that have a clearing short position of 10,000 shares or more per security and that are equal to at least one-half of one percent of the issue's total shares outstanding. NASD Rule 11830 generally requires that a contract involving a short sale in these securities, for the account of a customer or for an NASD member's own account, which has not resulted in delivery by the broker-dealer representing the seller within 10 business days after the normal settlement date (currently transaction date + 3 business days), must be closed

by the broker-dealer representing the seller by purchasing for cash or guaranteed delivery of securities of like kind and quality. This mandatory close-out requirement does not apply to bona-fide market making transactions and transactions that result in fully hedged or arbitrated positions.

C. Proposed Amendments

1. Short Sales

The Commission believes that these SRO requirements have not fully addressed the problems of naked short selling and extended fails to deliver. We believe it would be beneficial to establish a uniform standard specifying the procedures for all short sellers to locate securities for borrowing.⁴⁵ This would further the goals of regulatory simplification and avoidance of regulatory arbitrage, as well as address some areas not currently covered. We are therefore proposing to incorporate in proposed Regulation SHO a uniform "locate" rule applicable to all equity securities, wherever they are traded.⁴⁶ Proposed Rule 203 would prohibit a broker-dealer from executing a short sale order for its own account or the account of another person, unless the broker-dealer, or the person for whose account the short sale is executed (1) borrowed the security, or entered into an arrangement for the borrowing of the security, or (2) had reasonable grounds to believe that it could borrow the security so that it would be capable of delivering the securities on the date delivery is due.⁴⁷ Consistent with the current SRO requirements, the proposed rule would require that the locate be made and annotated in writing prior to effecting any short sale, regardless of the fact that the seller's short position may

³⁷ Such assurances include knowledge that the security is available for borrowing, conversion privileges, rights exercise, and the like. One test of reasonableness in short sales against convertible securities, rights and merger securities is whether the security needed for delivery can be exchanged in normal transfer time. A firm that normally relies on the stock loan market without advance borrowing can demonstrate compliance by switching to prior borrowing whenever the stock borrowing market in a particular security becomes tight." NYSE Rule 440C.10 Interp. /01. See also NYSE Information Memo 91-41 (providing further information regarding compliance with Rule 440C.10).

³⁸ *Id.*

³⁹ See NASD Rule 3370.

⁴⁰ According to the rule, the manner by which a member or person associated with a member annotates compliance with the affirmative determination requirement is to be decided by each member. Members may rely on "blanket" or standing assurances (i.e., "Easy to Borrow" lists) that securities will be available for borrowing on settlement date. For any short sales executed in Nasdaq National Market ("NNM") or exchange-listed securities, members also may rely on "Hard to Borrow" lists indicating NNM or listed securities that are difficult to borrow or unavailable for borrowing on settlement date provided that: (i) Any securities restricted pursuant to NASD Rule 11830 must be included on such a list; and (ii) the creator of the list attests in writing on the document or otherwise that any NNM or listed securities not included on the list are easy to borrow or are available for borrowing. Members are permitted to use Easy to Borrow or Hard to Borrow lists provided: (i) The information used to generate the list is no less than 24 hours old; and (ii) the member delivers the security on settlement date. Should a member relying on an Easy to Borrow or Hard to Borrow fail to deliver the security on settlement date, the NASD deems such conduct inconsistent with the terms of Rule 3370, absent mitigating circumstances adequately documented by the member. See NASD Rule 3370(b)(4)(C).

⁴¹ See NASD Notice to Members 99-98.

⁴² NASD IM-3350 contains language specifying what type of activity does not constitute bona fide market making: "Bona fide market making activity does not include activity that is unrelated to market making functions, such as index arbitrage and risk arbitrage that is independent from a member's market making functions. * * * IM-3350(a)(2). "Similarly, bona fide market making would exclude activity that is related to speculative selling strategies of the member or investment decisions of the firm and is disproportionate to the usual market making patterns or practices of the member in that security. The Association does not anticipate that a firm could properly take advantage of its market maker exemption to effectuate such speculative or investment short selling decisions. Disproportionate short selling in a market making account to effectuate such strategies will be viewed by the Association as inappropriate activity that does not represent bona fide market making and would therefore be in violation of Rule 3350." IM-3350(a)(3).

The NASD has instituted disciplinary actions against broker-dealers that the NASD found were abusing the exemption provided for bona-fide market making transactions. See, e.g., Hearing Panel Decision as to Respondents John Fiero and Fiero Brothers, Inc. (December 6, 2000) (decision affirmed by the National Adjudicatory Council on October 28, 2002); see also John Emshwiller, *NASD Moves to Bar Short Seller Fiero, Citing Alleged Manipulation of Stocks*, WSJ (January 9, 2001).

⁴³ NASD Rule 3370(b)(5) provides guidelines in determining the availability of the exemption for "bona-fide fully hedged" and "bona-fide fully arbitrated" positions.

⁴⁴ With respect to foreign securities, if the member has a fail to deliver in that security 90 days or older (except American Depositary Receipt and Canadian securities, which shall be subject to the 60 day provision).

⁴⁵ Some commenters to the Concept Release supported a single, workable approach to locating securities for borrowing before effecting short sales. See letter from Wilkie, Farr & Gallagher (488) (writing on behalf of Bear, Stearns & Co., Inc.; Credit Suisse First Boston Corp.; Deutsche Bank Securities, Inc.; JP Morgan Securities Inc.; PaineWebber Inc.; Prudential Securities Inc.; and Warburg Dillon Read LLC).

⁴⁶ See paragraph (b), Rule 203 of proposed Regulation SHO.

⁴⁷ We are interested in receiving comment on the manner in which persons could satisfy the "reasonable grounds" determination in the proposed rule. As noted above, the current SRO rules generally defer to members to decide the manner of compliance, and permit members to rely on blanket assurances that stock is available for borrowing, i.e., "hard to borrow" or "easy to borrow" lists. See, *supra* n. 40. We specifically request comment on whether this present method of compliance provides an accurate assessment of the current lending market in a manner that would not impede liquidity and the ability of market participants to establish short positions, while at the same time guarding against the noted problems inherent with large extended settlement failures.