

be closed out by purchasing securities the same day.<sup>48</sup> The Commission is proposing an exception from these requirements for short sales executed by specialists or market makers but only in connection with bona-fide market making activities.<sup>49</sup> We believe a narrow exception for market makers and specialists engaged in bona fide market making activities is necessary because they may need to facilitate customer orders in a fast moving market without possible delays associated with complying with the proposed "locate" rule. Moreover, we believe that most specialists and market makers seek a net "flat" position in a security at the end of each day and often "offset" short sales with purchases such that they are not required to make delivery under the security settlement system.

As an additional safeguard against some of the problems associated with naked short selling, we are proposing a delivery requirement targeted at securities where there is evidence of significant settlement failures. We are incorporating the same threshold currently used in NASD Rule 11830,<sup>50</sup> i.e., any security where there are fails to deliver at a clearing agency registered with the Commission of 10,000 shares or more per security, and that is equal to at least one-half of one percent of the issue's total shares outstanding.<sup>51</sup> We are incorporating this standard into proposed Rule 203 because we believe that the levels set in NASD Rule 11830 characterize situations where the ratio of unfulfilled delivery obligations at the clearing agency where trades are settled represents a significant number of shares relative to the company's total shares outstanding, thus requiring

remedial action designed to address potential negative effects. The proposed rule would specify that for short sales of any security meeting this threshold, the selling broker-dealer must deliver the security no later than two days after the settlement date.<sup>52</sup> We believe a two-day grace period is appropriate to allow for transfer delays or delays due to a variety of circumstances that prevent timely delivery.<sup>53</sup> If for any reason such security was not delivered within two days after the settlement date, the rule would restrict the broker-dealer, including market makers, from executing future short sales in such security for the person for whose account the failure to deliver occurred unless the broker-dealer or the person for whose account the short sale is executed borrowed the security, or entered into a bona fide arrangement to borrow the security, prior to executing the short sale and delivered on settlement date. This restriction would be in effect for a period of 90 calendar days.<sup>54</sup> In addition, the rule would require the rules of the registered clearing agency that processed the transaction to include the following provisions: (A) A broker or dealer failing to deliver such securities shall be referred to the NASD and the designated examining authority for such broker-dealer for appropriate action;<sup>55</sup> and (B) The registered clearing agency shall withhold a benefit of any mark-to-market amounts or payments that otherwise would be made to the party failing to deliver,<sup>56</sup> and take other

appropriate action, including assessing appropriate charges against the party failing to deliver. Both of these requirements should assist the Commission in preventing abuses and promote the prompt and accurate clearance and settlement of securities transactions.

These proposed requirements in Rule 203 would differ from the current SRO rules in several respects. First, the proposals require action two days after settlement, as opposed to the current ten days after settlement provided in Rule 11830.<sup>57</sup> Further, the mandatory close-out provision in NASD Rule 11830 currently only applies to Nasdaq securities. We believe that securities with lower market capitalization may be more susceptible to abuse, and therefore believe that these additional delivery requirements should be extended to all equity securities registered under Section 12 of the Exchange Act. Finally, although market makers engaged in bona fide market making are currently exempted from NASD Rule 11830, we believe that extended failures to deliver appear characteristic of an investment or trading strategy, rather than being related to market making. We believe it is questionable whether a market maker carrying a short position in a heavily shorted security for an extended period of time is in fact engaged in providing liquidity for customers, or rather is engaged in a speculative trading strategy. Therefore, we are not proposing an exception from these additional delivery requirements for short sales in connection with market making.

In our view, these delivery requirements would protect and enhance the operation, integrity and stability of the markets and the clearance and settlement system. In

delivery. In situations where the value of a security that is the subject of a failure to deliver is increasing, NSCC collects the mark from the party that failed to deliver and passes it on to the party that failed to receive the securities. Conversely, in a situation where the value of the security is decreasing, NSCC collects the mark from the party that failed to receive the securities and passes it on to the party that failed to deliver. Under the CNS system, a participant does not receive the actual contract value of the securities (i.e., the proceeds from their sale) until actual delivery of securities is made. See National Securities Clearing Corporation Rules of Procedures Rule 11. Nevertheless, we believe that withholding the benefit of mark-to-market amounts from the party failing to deliver in a security meeting the specified threshold would serve as a financial incentive to comply with the borrow and delivery requirements during the 90-day restricted period.

<sup>57</sup> We solicit comment on any legitimate reasons why a short seller may be unable to deliver securities by at least T+5. We may then choose to except particular types of transactions, or add a specified grace period.

<sup>48</sup> See, e.g., *Ko Securities, Inc. and Terrance Y. Yoshikawa*, Securities Exchange Act Release No. 48550 (September 26, 2003) (holding that an affirmative determination must be made before the securities are sold short regardless of whether the short seller repurchases securities on the same day).

<sup>49</sup> The exemption for bona-fide market making activities would exclude activity that is related to speculative selling strategies or investment decisions of the broker-dealer or associated person and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.

<sup>50</sup> The National Securities Clearing Corporation (NSCC) currently tracks this information on fails to deliver and provides it to Nasdaq for purposes of administering NASD Rule 11830. Thus, we do not believe that the threshold proposed here would impose unduly burdensome data collection requirements.

<sup>51</sup> For example, if an issuer had 1,000,000 shares outstanding, one-half of one percent (.005) would be 5,000 shares. An aggregate fail to deliver position at a clearing agency of 10,000 shares or more would thus meet the threshold. If an issuer had 10,000,000 shares outstanding, one-half of one percent would be 50,000 shares. An aggregate fail to deliver position at a clearing agency of 50,000 shares or greater would meet the threshold.

<sup>52</sup> When the trade fails to settle on normal settlement date (i.e., T+3), the broker-dealer would have to take actions, such as borrowing the security or effecting a purchase in the cash market, so that actual delivery is made by T+5.

<sup>53</sup> Unlike NASD Rule 11830, which provides for delivery of securities meeting this threshold to be delivered within 10 business days after the normal settlement date, we propose a two-day period because we believe it is reasonable period to allow for transfer delays or delays due to some other characteristic of the security while preventing unfulfilled delivery obligations from extending for a period that we believe is characteristic of a more significant problem.

<sup>54</sup> In this context, we believe that a 90-day restricted period is an appropriate consequence for a failure to deliver and a deterrent to prevent failures to deliver in the future. The Federal Reserve Board has taken this approach with respect to transactions in cash accounts where the securities are sold before they have been fully paid for. See, 12 CFR 220.8(c), Regulation T.

<sup>55</sup> Referral to the designated examining authority would allow for monitoring of broker or dealers not complying with proposed Rule 203 and allow for possible disciplinary action. In the case of any fail to deliver occurring at the Canadian Depository for Securities (CDS), the registered clearing agency would refer CDS to the Ontario Securities Commission for appropriate action.

<sup>56</sup> As part of its Continuous Net Settlement system (CNS) NSCC marks-to-market each day positions for which participants failed to make