

a short sale order from a broker-dealer that is not an NASD member ("non-member broker-dealer") a member must make an affirmative determination that the member will receive delivery of the security from the non-member broker-dealer or that the member can borrow the security on behalf of the non-member broker-dealer for delivery by settlement date. The proposed rule change was published for comment in the **Federal Register** on January 23, 2002.<sup>3</sup> The Commission received one comment letter on the proposal. On July 18, 2003, the NASD submitted Amendment No. 1 to the proposed rule change. On September 15, 2003, the NASD submitted Amendment No. 2 to the proposed rule change. This order approves the proposed rule change, as amended, and solicits comments from interested persons on Amendment Nos. 1 and 2.

## II. Description of the Proposal

NASD Rule 3370(b)(2)(A) provides that no member or person associated with a member shall accept a short sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. For purposes of NASD Rule 3370(b)(2), the term "customer" is defined in NASD Rule 0120(g) and excludes a broker or dealer.

As a result, the requirements of NASD Rule 3370(b)(2)(A) generally do not apply directly to orders received by a member from another broker-dealer (the "originating broker-dealer"). This does not present regulatory concerns where the originating broker-dealer is also an NASD member because, as a member, the originating broker-dealer would have an independent obligation to comply with the requirements under NASD Rule 3370(b)(4)(B) ("Affirmative Determination Requirements") with respect to the order. Non-member broker-dealers, however, are not subject to NASD rules and, therefore, are not independently required to comply with the NASD's Affirmative Determination Requirements. Thus the Affirmative Determination Requirements generally do not apply to short sale orders that originate with a non-member broker-dealer and are subsequently routed to an NASD member.

To address these concerns, the proposed rule change would amend

NASD Rule 3370(b)(2)(A) to require that no member or person associated with a member shall accept a short sale order for any customer, or any non-member broker-dealer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or non-member broker-dealer, or that the member can borrow the security on behalf of the customer or non-member broker-dealer for delivery by settlement date. In such instances, members also would be required to comply with the corresponding recordkeeping requirements under NASD Rule 3370(b)(4)(B).

While NASD members generally are required to make affirmative determinations for both customer and proprietary orders, there are limited exceptions for proprietary orders that are bona fide market making, bona fide fully hedged or bona fide fully arbitrated transactions.<sup>4</sup> Under the proposed rule change, if a member can establish and document that a proprietary order it has received from a non-member broker-dealer meets one of these exceptions, it would be in compliance with the proposed amendments to the Affirmative Determination Requirements.

## III. Comments and NASD Response

The Commission received one comment letter from Island ECN, Inc. ("Island"). Island's comment letter makes two basic points. First, it suggests the Commission should not approve the proposal until the issue of the Nasdaq primary market maker ("PMM") standards exemption is addressed. Second, Island argues that the NASD offers no factual basis for the proposal. The NASD believes that no changes to the proposal are necessary in response to Island's letter.

Regarding Island's first point, the NASD's response is that Island confuses the requirements of the bid test, which addresses the price at which a short sale may be made, with the affirmative determination requirement, which prevents abusive short selling and ensures that short sellers satisfy their settlement obligations. According to the NASD, short selling members must comply with both affirmative determinations and bid test requirements. According to the NASD, the current rule applies only to a member's proprietary orders and customer orders, which excludes

another broker or dealer by definition.<sup>5</sup> NASD proposes to close this gap.

Further, NASD has made similar changes NASD Rule 2860 to the option position, exercise and reporting requirements.<sup>6</sup>

NASD's response to Island second point is that NASD has set forth a factual basis for approval of the proposal consistent with section 15A(b)(6) of the Act.<sup>7</sup> According to NASD, hard evidence of violative conduct sought by Island has not been necessary for similar proposed rule changes, and, if required, would undermine the ability of self-regulatory organizations to close gaps in their rules. Moreover, NASD represents that it has observed cases of member firms that have not complied with short sale requirements for orders received from non-member broker-dealers. NASD believes that orders from non-member broker-dealers have the potential for fails to deliver just as short sales by other persons subject to the rule.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 1 and 2 to the proposed rule change, including whether Amendment Nos. 1 and 2 are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-2001-85 and should be submitted by December 15, 2003.

## V. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder

<sup>5</sup> See NASD Rule 0120(g).

<sup>6</sup> Securities Exchange Act Release No. 43718 (December 13, 2000), 65 FR 80969 (December 22, 2000) (approving SR-NASD-2000-36).

<sup>7</sup> 15 U.S.C. 78o-3(b)(6).

<sup>3</sup> See Securities Exchange Act Release No. 45257 (January 9, 2002), 67 FR 3249.

<sup>4</sup> NASD Rule 3370(b)(2)(B).