

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is 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 at 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-2002-18 and should be submitted by April 1, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Jill M. Peterson,

Assistant Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45499, File No. SR-NASD-98-26 Amend. No. 12]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Order Granting Accelerated Approval to Amendment No. 12 to a Proposed Rule Change Relating to an Extension of the NASD Short Sale Rule and Continued Suspension of Primary Market Maker Standards Set Forth in NASD Rule 4612

March 4, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ notice is hereby given that on February 28, 2002, the National Association of Securities Dealers, Inc., through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("Commission" or "SEC")

the proposed rule change as described in Items I and II below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq is proposing to extend the pilot program of the NASD short sale rule ("Rule 3350") from March 1, 2002 until December 15, 2002. Nasdaq is also seeking to continue the suspension of the effectiveness of the Primary Market Maker ("PMM") standards currently set forth in NASD Rule 4162 also from March 1, 2002 until December 15, 2002. The text of the proposed rule change is as follows. Additions are italicized; deletions are bracketed.

NASD Rule 3350

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(l) This section shall be in effect until December 15, 2002 [March 1, 2002].

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change. The text of these statements may be examined at the places specified in Item III below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Background and Description of the NASD's Short Sale Rule

Section 10(a) of the Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange, as needed to protect investors. Although the Commission has regulated short sales since 1938, that regulation has been limited to short sales of exchange-listed securities. In 1992, Nasdaq, believing that short-sale regulation is important to the orderly operation of securities markets, proposed a short sale rule for trading of its National Market securities that incorporates the protections provided by Rule 10a-1 under the Act. On June 29, 1994, the SEC approved Rule 3350 applicable to short sales² in Nasdaq

² A short sale is a sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. To determine whether a sale is a short sale members must adhere to the definition of a "short sale" contained in Rule 3b-

National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.³ The NASD and the Commission have extended Rule 3350 numerous times, most recently, until March 1, 2002. Rule 3350 employs a "bid" test rather than a tick test because Nasdaq trades are not necessarily reported to the tape in chronological order. The Rule prohibits short sales at or below the inside bid when the current inside bid is below the previous inside bid. Nasdaq calculates the inside bid from all market makers in the security (including bids for exchanges trading Nasdaq securities on an unlisted trading privileges basis), and disseminates symbols to denote whether the current inside bid is an "up-bid" or a "down-bid." To effect a "legal" short sale on a down-bid, the short sale must be executed at a price at least \$.01 above the current inside bid. Rule 3350 is in effect from 9:30 a.m. until 4 p.m. each trading day.

To reduce the compliance burdens on its members, Rule 3350 also incorporates seven exemptions contained in Rule 10a-1 under the Act, that are relevant to trading on Nasdaq.⁴ For example, in an effort to not constrain the legitimate hedging needs of options market makers, Rule 3350 also contains a limited exception for standardized options market makers. The Rule also contains an exemption for warrant market makers similar to the one available for options market makers.

B. Background of the Primary Market Maker Standards

To ensure that market maker activities that provide liquidity and continuity to the market are not adversely constrained when the Rule is invoked, Rule 3350 provides an exemption for "qualified" Nasdaq market makers (*i.e.*, market makers that meet the PMM standards). Presently, NASD Rule 4612 provides

3 under the Act, which is incorporated into Nasdaq's short sale rule by NASD Rule 3350(k)(1).

³ See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994) ("Short Sale Rule Approval Order").

⁴ See NASD Rule 3350(c)(2)-(8). The Rule also provides that a member not currently registered as a Nasdaq market maker in a security that has acquired the security while acting in the capacity of a block positioner shall be deemed to own such security for the purposes of the Rule notwithstanding that such member may not have a net long position in such security if and to the extent that such member's short position in such security is subject to one or more offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities. In addition, the NASD has recognized that SEC staff interpretations to Rule 10a-1 under the Act dealing with the liquidation of index arbitrage positions and an "international equalizing exemption" are equally applicable to the NASD's short sale rule.

¹⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

that a member registered as a Nasdaq market maker pursuant to NASD Rule 4611 may be deemed a PMM if that member meets certain threshold standards.

Since Rule 3350 has been in effect, there have been three methods used to determine whether a market maker is eligible for the market maker exemption. Specifically, from September 4, 1994 through February 1, 1996, Nasdaq market makers that maintained a quotation in a particular NNM security for 20 consecutive business days were exempt from the Rule for short sales in that security, provided the short sales were made in connection with bona fide market making activity ("the 20-day" test). From February 1, 1996 until the February 14, 1997, the "20-day" test was replaced with a four-part quantitative test known as the PMM standards.⁵

On February 14, 1997, the PMM standards were waived for all NNM securities due to the effects of the SEC's Order Handling Rules and corresponding NASD rule change and system modifications on the operation of the four quantitative standards.⁶ For example, among other effects, the requirement that market makers display customer limit orders adversely affected the ability of market makers to satisfy the "102% Average Spread Standard". Since that time all market makers have been designated as PMMs.

In March 1998, Nasdaq proposed PMM standards that received substantially negative comments.⁷ In light of those comments, Nasdaq staff convened an advisory subcommittee to develop new PMM standards ("Subcommittee") in August 1998. The Subcommittee met nine times and formulated new PMM standards. NASD/Nasdaq staff requested to meet with the Commission staff and the Subcommittee

⁵ Under the PMM standards, a market maker was required to satisfy at least two of the following four criteria each month to be eligible for an exemption from the short sale rule: (1) The market maker must be at the best bid or best offer as shown on Nasdaq no less than 35 percent of the time; (2) the market maker must maintain a spread no greater than 102 percent of the average dealer spread; (3) no more than 50 percent of the market maker's quotation updates may occur without being accompanied by a trade execution of at least one unit of trading; or (4) the market maker executes 1½ times its "proportionate" volume in the stock. If a PMM did not satisfy the threshold standards after a particular review period, the market maker lost its designation as a PMM (i.e., the "P" next to its market maker identification was removed). Market makers could requalify for designation as a PMM by satisfying the threshold standards in the next review period.

⁶ See Securities Exchange Act Release No. 38294 (February 17, 1997), 62 FR 8289 (February 24, 1997).

⁷ See Securities Exchange Act Release No. 39189 (March 30, 1998), 63 FR 16841 (April 6, 1998).

to receive informal feedback on the new PMM standards. This meeting occurred on December 9, 1998. At the conclusion of the meeting, Commission staff noted the progress made by the Subcommittee and requested time to digest and more carefully analyze the proposed new PMM standards.

On July 29, 1999, members of the Nasdaq staff conducted a conference call with members of the Commission staff to receive feedback on the PMM standards that Nasdaq presented at the December 9, 1998 meeting. During the meeting, the Commission staff requested that Nasdaq modify several of the proposed standards and analyze the impact of those modifications on the primary market maker determination. On September 27, 1999, Nasdaq reported that the NASD Economic Research staff had analyzed data based on the Commission's recommended revisions, and concluded that the Commission's modified standards produced unfavorable results. Nasdaq requested that the Commission comment on the outcome of this test "as we intend to communicate your comments to the Subcommittee in an effort to resume the process of developing new standards."⁸

Nasdaq suspended development of PMM standards in late-1999 after the Commission signaled the securities industry that it is considering fundamental changes to Rule 10a-1 under the Act, changes that could affect the manner in which Nasdaq and the other markets regulate short sales. In October 1999, the Commission issued a Concept Release on Short Sales in which it sought comment on, among other things, revising the definition of short sale, extending short sale regulation to non-exchange listed securities, and eliminating short sale regulation altogether. Nasdaq believed that it would be inappropriate for Nasdaq to dramatically alter its regulation of short sales while the Commission is considering fundamentally changing Rule 10a-1 under the Act. At the request of the staff of the Division of Market Regulation, Nasdaq has resumed development of PMM standards and has been working with the Commission staff toward that goal.

C. Proposal To Extend the Short Sale Rule and Suspend the PMM Standards

Nasdaq believes that it is in the best interest of investors to extend the short

⁸ See Letter, dated September 27, 1999 from John F. Malitzis, Assistant General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division of Market Regulation, SEC.

sale regulation pilot program. When the Commission approved the NASD's short sale rule on a pilot basis, it made specific findings that the Rule was consistent with sections 11A, 15A(b)(6), 15A(b)(9), and 15A(b)(11) of the Act. Specifically, the Commission stated that, "recognizing the potential for problems associated with short selling, the changing expectations of Nasdaq market participants and the competitive disparity between the exchange markets and the OTC market, the Commission believes that regulation of short selling of Nasdaq National Market securities is consistent with the Act."⁹ In addition, the Commission stated that it "believes that the NASD's short sale bid-test, including the market maker exemptions, is a reasonable approach to short sale regulation of Nasdaq National Market securities and reflects the realities of its market structure."¹⁰ Nasdaq believes the benefits that the Commission recognized when it first approved Rule 3350 apply with equal force today.

Similarly, the concerns that caused the Commission to waive the PMM standards in February 1997 continue to exist today. Nasdaq and the Commission agreed to waive the PMM standards for three reasons that were discovered only after the Order Handling Rules were implemented.¹¹ Through late-1999, Nasdaq worked diligently to address those concerns to the Commission's satisfaction, including convening a special subcommittee on PMM issues, proposing two different sets of PMM standards, and being continuously available and responsive to Commission staff to discuss this issue. Despite these efforts, the Commission and Nasdaq were unable to establish satisfactory PMM standards. At the request of Commission staff, Nasdaq has begun developing PMM standards suitable to today's rapidly changing marketplace. Re-instating the PMM standards set forth in NASD Rule 4612 would be extremely disruptive to the market and harmful to investors.

⁹ See Short Sale Rule Approval Order, *supra* note 3.

¹⁰ *Id.*

¹¹ Implementation of the Order Handling Rules created the following three issues: (1) Many market makers voluntarily chose to display customer limit orders in their quotes although the Limit Order Display Rule did not require it at that time; (2) SOES decrementation for all Nasdaq stocks significantly affected market makers' ability to meet several of the primary market maker standards; and (3) with the inability to meet the existing criteria for a larger number of securities, a market maker may be prevented from registering as a primary market maker in an initial public offering because it fails to meet the 80% primary market maker test contained in Rule 4612(g)(2)(B).

D. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

E. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Comments were neither solicited nor received.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is 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 the filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by April 1, 2002.

IV. Commission's Findings and Order Granting Accelerated Approval of the Amendment

After careful consideration, the Commission finds, for the reasons set forth below, that the extension of the Short Sale Rule Pilot and the suspension of the existing PMM standards until December 15, 2002 is consistent with the requirements of the Act and the rules and regulations thereunder. In particular, the extension is consistent with section 15A(b)(6)¹² of the Act, which requires that the NASD's rules be designed, among other things, to remove impediments to and perfect the mechanism of a free and open market and a national market system and to promote just and equitable principles of trade.

¹² 15 U.S.C. 78o-3(b)(6).

The Commission finds that the continuation of the Short Sale Rule Pilot and the continued suspension of the PMM standards will maintain the status quo while the Commission is considering amending Rule 10a-1 under the Act. This extension of the pilot and continued suspension of the PMM standards is subject to modification or revocation should the Commission amend Rule 10a-1 under the Act in a manner as to deem the extension or suspension unnecessary or in conflict with any adopted amendments.¹³

The Commission finds good cause for approving the extension of the Short Sale Rule Pilot and the suspension of existing PMM standards prior to the 30th day after the date of publication of notice of the filing in the **Federal Register**. It could disrupt the Nasdaq market and confuse market participants to reintroduce the previous PMM standards while new PMM standards are being developed, and while the Commission considers amending Rule 10a-1 under the Act.

It is therefore ordered, pursuant to section 19(b)(2) of the Act,¹⁴ that Amendment No. 12 to the proposed rule change, SR-NASD-98-26, which extends the NASD Short Sale Rule Pilot and suspends the PMM standards through December 15, 2002, is approved on an accelerated basis.¹⁵

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁶

Jill M. Peterson,

Assistant Secretary.

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¹³ Absent an exemption, Rule 10a-1 under the Act would apply to Nasdaq on Commission approval of its exchange registration.

¹⁴ 15 U.S.C. 78s(b)(2).

¹⁵ In approving Amendment No. 12, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

¹⁶ 17 CFR 200.30-3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45503; File No. SR-NASD-2002-29]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. To Extend a Pilot Program Making Available Certain Nasdaq Services and Facilities Until 6:30 p.m. Eastern Time

March 5, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 4, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by Nasdaq. Nasdaq filed the proposal pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ which renders the proposal effective upon filing with the Commission.⁵ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq proposes to extend through September 1, 2002 its pilot program making available several Nasdaq services and facilities until 6:30 P.M. Eastern Time. No substantive changes are being made to the pilot program, other than extending the operation of the pilot program through September 1, 2002. The text of the proposed rule change is available at the Association and at the Commission.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for its proposal and discussed any comments it received regarding the proposal. The text of these

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

⁵ Nasdaq asked the Commission to waive the 5-day pre-filing notice requirement and the 30-day operative delay. See Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).