

**SECURITIES AND EXCHANGE COMMISSION**  
**(Release No. 34-39819; File No. SR-NASD-98-26)**

**March 30, 1998**

**Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Partial Approval to Proposed Rule Change by the National Association of Securities Dealers, Inc. to Implement, On a Pilot Basis, New Primary Nasdaq Market Maker Standards For All Nasdaq National Market Securities and to Extend the Short Sale Rule Pilot**

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 19, 1998, the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly-owned subsidiary, The Nasdaq Stock Market, Inc. (“Nasdaq”), filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule changes as described in Items I and II below, which Items have been prepared by Nasdaq. On March 25, 1998, Nasdaq submitted to the Commission Amendment No. 1 to the proposed rule changes.<sup>3</sup> On March 26, 1998, Nasdaq submitted to the Commission Amendment No. 2 to the proposed rule changes.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. As

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<sup>1</sup>15 U.S.C. § 78s(b)(1).

<sup>2</sup>17 CFR 240.19b-4.

<sup>3</sup>See Letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated March 25, 1998.

<sup>4</sup>See Letter from Robert E. Aber, Senior Vice President and General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division of Market Regulation, Commission, dated March 26, 1998.

discussed below, the Commission is also granting accelerated approval to a portion of the proposal.

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

The NASD and Nasdaq propose to amend the Primary Nasdaq Market Maker (“PMM”) standards for all Nasdaq National Market (“NNM”) securities, which are found in NASD Rule 4612, and to implement the proposed revised PMM standards on a pilot basis beginning on May 1, 1998, and extending until November 1, 1998. Additionally, the NASD and Nasdaq are proposing to: 1) continue the current suspension of existing PMM standards through May 1, 1998 (the start date of the new PMM pilot); and 2) extend the pilot of the NASD's short sale rule -- NASD Rule 3350 (“Short Sale Rule”) -- including the market maker exemption to that rule and the definition of “legal” short sale until November 1, 1998 (the end date of the proposed PMM pilot). As noted below, as part of the PMM pilot program, the NASD and Nasdaq will shortly submit amendments to the Short Sale Rule, which would exempt from the Short Sale Rule certain customer facilitating, liquidity-providing transactions, regardless of whether the broker/dealer is qualified as a PMM. Proposed new language is italicized; proposed deletions are in brackets.

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**NASD Rule 4612. Primary Nasdaq Market Maker Standards**

(a) A member registered as a Nasdaq market maker pursuant to Rule 4611 may be deemed to be a Primary Nasdaq Market Maker in Nasdaq National Market (“NNM”) securities if the market maker (complies with) achieves the threshold standards ((as established and published by the Association from time to time)) in the following qualification criteria:

(1) (amount of time a dealer maintains a quotation that represents the best bid or best offer as shown in) degree of liquidity contribution to The Nasdaq Stock Market as measured by the Net Liquidity Ratio<sup>5</sup>; and

(2) (relation of individual dealer spread to average dealer spread) a market maker's proportionate share of proprietary share-volume ("proportionate volume") or the market maker's proportionate share of proprietary trades ("proportionate trades").<sup>6</sup>  
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(3) frequency of dealer quotation updates without a corresponding execution in the security occurring within three minutes before or after a quotation update. <sup>7</sup>)

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<sup>5</sup>The Net Liquidity Ratio ("NLR") formula accords credit for liquidity contribution: 1) in an "up market" by accumulating all sales, irrespective of price; and 2) in a "down market" by accumulating all purchases, irrespective of price. These trades are then divided by total shares traded in both up and down markets, excluding volume during neutral periods, sales at the inside offer during down markets, and purchases at the inside bid during up markets. In addition to excluding from the denominator of the NLR sales at the inside offer during down markets and purchases at the inside bid during up markets, these sales and purchases are excluded from the numerator of the NLR. The result is expressed as a ratio with a potential value between zero and one.

For the purposes of calculating NLR, the direction of the market is defined by looking at the five minute period prior to the trade report. If there has been no change in the bid price during that time, the last bid direction governs. That is, if the current best (inside) bid displayed in The Nasdaq Stock Market is below the preceding best (inside) bid ("down bid"), the market is deemed down, and if the current best (inside) bid displayed in The Nasdaq Stock Market is above the preceding best (inside) bid ("up bid"), the market is deemed up. If there has been a change during the previous five minutes, then the formula looks to the prior four changes and takes the predominant direction as the indicator. Thus, if at least three of the last four changes are down bids the market is deemed down, and if at least three of the last four changes are up bids the market is deemed up. If the changes are evenly split, the market is deemed neutral.

<sup>6</sup>A market maker's proportionate volume shall be determined by: dividing the market maker's total proprietary share-volume in a stock by all market maker proprietary share-volume for that stock; and then multiplying that ratio by the total number of registered market makers in the stock. For example, if a market maker transacts 10% of the total proprietary share-volume in a stock with 10 registered market makers, the market maker's proportionate volume would be 1.0. A market maker's proportionate trades shall be determined by: dividing the market maker's total number of proprietary trades in a stock by the total number of proprietary trades by all market makers in that stock; and then multiplying that ratio by the total number of registered market makers in the stock. Subparagraph (b)(1)(ii) establishes the applicable thresholds for proportionate volume and proportionate trades.

<sup>7</sup>(The threshold standards initially shall be established as:

( b) A market maker for a Nasdaq National Market security must satisfy the threshold standards in at least two of the criteria in paragraph (a) in order to be designated a Primary Nasdaq Market Maker in that security; provided however, that if a market maker satisfies only one of the criteria, it may qualify as a Primary Nasdaq Market Maker if it also accounts for a threshold level of proportionate volume in the security (as established and published by the Association from time to time).<sup>8)</sup>

(b)(1) Except as provided in subparagraphs (b)(2) and (b)(3), to be designated as a Primary Nasdaq Market Maker in a particular NNM security a market maker must achieve:

(i) the NLR threshold; and<sup>9</sup>

(ii) the threshold for proportionate volume or the threshold for proportionate trades.<sup>10</sup>

(b)(2) If less than 50% of all registered market makers qualify as Primary Nasdaq Market Makers under subparagraph (b)(1), Nasdaq shall rank those market makers that achieve only the NLR threshold by:

(i) the market makers' proportionate volume, and shall designate (from highest to lowest ranked) such market makers as Primary Nasdaq Market Makers until the

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(a) a market maker must maintain the best bid or best offer as shown on Nasdaq no less than 35% of the time;

(b) a market maker must maintain a spread no greater than 102% of the average dealer spread;

(c) no more than 50% of a market maker's quotation updates may occur without being accompanied by a trade execution of at least one unit of trading.

The Board of Governors reserves the authority to rescind or modify one or more of the threshold standards immediately upon a finding that the standard is operating in a manner that is unfair to a class of investors or members, or that continued imposition of the standard results in a substantial adverse impact on the liquidity or market quality of the Nasdaq market.)

<sup>8)</sup>(The threshold proportionate volume standard initially shall require a market maker to account for volume of at least 1 ½ times its proportionate share of overall volume in the stock for the review period.)

<sup>9)</sup>The NLR threshold initially shall be established as 0.67.

<sup>10)</sup>The threshold for proportionate volume and proportionate trades shall be 1.0 for each. Accordingly, a market maker must account for at least one times its proportionate share of all share-volume in the stock or must account for at least one times its proportionate share of all trades for the stock during the review period. For example, if during the review period a stock had 10 market makers and had an overall share-volume of 1,000,000 shares and 15,000 trades, a market maker would have to transact one-tenth of all share-volume or trades -- 100,000 in share-volume or 1,500 trades.

total number of market makers qualifying under subparagraphs (b)(1) and (b)(2)(i) reaches an amount up to but not exceeding 50% of all the registered market makers in that security; and

(ii) the market makers' proportionate trades, and shall designate (from highest to lowest ranked) such market makers as Primary Nasdaq Market Makers until the total number of market makers qualifying under subparagraphs (b)(1) and (b)(2)(ii) reaches an amount up to but not exceeding 50% of all the registered market makers in that security.<sup>11</sup>

(b)(3) If the number of registered market makers in a NNM security is eight (8) or fewer, a market maker shall qualify as a Primary Nasdaq Market Maker without regard to its proportionate volume or proportionate trades in that stock, provided it achieves the NLR threshold.

(c) Unless otherwise provided, (T)the review period for (review of) market maker performance in each of the qualification criteria in (paragraph) subparagraphs (a), (b), (paragraph) and (g)(1)(B), and paragraph (g)(2)(B)(ii) shall be one calendar month; provided, however, that if a market maker that is a Primary Nasdaq Market Maker would fail to maintain that status based on the application of the applicable thresholds for a particular month, the review period shall be that month (up to and including the last trading day of the month) and the prior month.

(d) If, after the applicable review period, a market maker does not satisfy the threshold standards for the criteria in (paragraph) subparagraphs (a) and (b), the Primary Nasdaq Market Maker designation shall be withheld commencing on the next business day following notice of failure to (comply with) achieve the standards.

(e) Market makers may requalify for designation as a Primary Nasdaq Market Maker by satisfying the threshold standards for the next review period.

(f) A market maker may request reconsideration of the notice to withhold the Primary Nasdaq Market Maker designation.

(1) Grounds for requests for reconsideration shall be limited to:

(A) system failure; or

(B) excused market maker withdrawal status (; or

(C) where a market maker failed to qualify under the criteria set forth in paragraph (a)(3) because of activity in a related derivative or convertible

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<sup>11</sup>The 50% levels set forth in subparagraphs (b)(2)(i) and (b)(2)(ii) shall be fixed and not subject to modification by Nasdaq, so that if a market maker meets the NLR threshold and falls within the top 50% of market makers when ranked by proportionate volume or the top 50% of market makers when ranked by proportionate trades, the market maker shall automatically be designated as a Primary Nasdaq Market Maker. The only instance in which Nasdaq would designate Primary Nasdaq Market Makers in an amount less than 50% of all registered market makers, would be if less than 50% of the registered market makers achieve the NLR threshold.

When there is an odd number of registered market makers in a security, Nasdaq will round up to calculate the "50%" level (i.e., 50% level = (number of market makers +1)/2).

security, or activity in a security subject to derivative pricing mechanisms, such as currency differentials with foreign stocks.)

(2) Requests for reconsideration must be sent in writing to Nasdaq Market Operations (within 24 hours of the determination to withhold the Primary Nasdaq Market Maker designation).

(3) Requests for reconsideration will be reviewed by the Market Operations Review Committee, whose decisions are final and binding on the members.

(g) In registration situations:

(1) To register and immediately become a Primary Nasdaq Market Maker in a Nasdaq National Market security, a member must be a Primary Nasdaq Market Maker in 80% of the securities in which it has registered. If the market maker is not a Primary Nasdaq Market Maker in 80% of its stocks, it may qualify as a Primary Nasdaq Market Maker in (that stock) a particular Nasdaq National Market security if the market maker registers in (the stock) that security as a regular Nasdaq market maker and satisfies the qualification criteria for the next review period, except that if the market maker is registered in the security on or before the fourteenth calendar day of the month, the review period shall be that calendar month.

(2) Notwithstanding paragraph (g)(1) above, after an offering in a stock has been publicly announced or a registration statement has been filed with the Securities and Exchange Commission, no market maker may register in the stock as a Primary Nasdaq Market Maker unless it meets the requirements set forth below:

(A) For secondary offerings:

(i) the secondary offering has become effective and the market maker has satisfied the qualification criteria in the time period between registering in the security and the offering becoming effective; provided, however, that if the member is a manager or co-manager of the underwriting syndicate for the secondary offering and it is a (PMM) Primary Nasdaq Market Maker in 80% or more of the Nasdaq National Market securities in which it is registered, the member is eligible to become a (PMM) Primary Nasdaq Market Maker in the issue prior to the effective date of the secondary offering regardless of whether the member was a registered market maker in the stock before the announcement of the secondary offering; or

(ii) the market maker has satisfied the qualification criteria for 40 calendar days.

(B) For initial public offerings (IPOs):

(i) the market maker may register in the offering and immediately become a Primary Nasdaq Market Maker if it is a Primary Nasdaq Market Maker in 80% of the securities in which it has registered; provided however, that if, at the end of the first review period, the Primary Nasdaq Market Maker has

withdrawn on an unexcused basis from the security or has not satisfied (the qualification criteria) the applicable thresholds, it shall not be afforded a Primary Nasdaq Market Maker designation on any subsequent initial public offerings for the next 10 business days; or

(ii) the market maker registers in the stock as a regular Nasdaq market maker and satisfies the qualification criteria for the next review period, except that if the market maker is registered in the security on or before the fourteenth calendar day of the month, the review period shall be that calendar month.

(C) For purposes of subparagraph (B)(i) above:

(i) an issue ceases to be an IPO once it has traded on Nasdaq for five (5) business days; and

(ii) the applicable first review period for IPOs that come to market during the last five (5) business days of a month is the calendar month after the month in which the IPO commenced trading on Nasdaq.

(3) Notwithstanding subparagraph (g)(1) or (g)(2) above, after a merger or acquisition has been publicly announced, a Primary Nasdaq Market Maker in one of the two affected securities may immediately register as a Primary Nasdaq Market Maker in the other merger or acquisition security pursuant to the same-day registration procedures in Rule 4611.

(h) (The Board of Governors may modify the threshold standards set forth in paragraphs (a) and (b) above if it finds that maintenance of such standards would result in an adverse impact on a class of investors or on Nasdaq.) This rule shall be in effect beginning May 1, 1998, and remain in effect until November 1, 1998.

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## **NASD Rule 3350**

(a) - (k) No Changes

(l) This Rule shall be in effect until (April 15, 1998) November 1, 1998.

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

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received

on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

The NASD and Nasdaq are proposing to amend the PMM standards, as described below, and to implement these revised PMM standards on a six-month pilot basis beginning May 1, 1998, and continuing until November 1, 1998. The NASD and Nasdaq are also proposing to extend the current suspension of the former PMM standards until the proposed PMM pilot program is implemented on May 1, 1998, and to extend the pilot program of the Short Sale Rule until November 1, 1998.

**Background.** On January 20, 1997, the Commission began phasing in new order handling rules (“Order Handling Rules”), which, among other things, require Nasdaq market makers to display in their quotes customer limit orders that improve the market maker's quoted price or size.<sup>12</sup> With the implementation of the Order Handling Rules, trading in Nasdaq migrated to a more order-driven, rather than quote-driven, environment because market maker's now are required to reflect customer limit orders (not only proprietary interests) in their quotations. The implementation of the Order Handling Rules, however, rendered the

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<sup>12</sup>See Securities Exchange Act Release No. 37619A (September 6, 1996) 61 FR 48290 (September 12, 1996) (“Order Handling Rules Adopting Release”). Specifically, the SEC adopted Rule 11Ac1-4, the Limit Order Display Rule, which requires the display of customer limit orders: (1) that are priced better than a market maker's quote; or (2) that add to the size of a market maker's quote when the market maker is at the best price in the market. Id.

PMM standards significantly less relevant because the criteria in NASD Rule 4612<sup>13</sup> were premised on a quote-driven market; that is, these standards were based primarily on a market maker's quotes in relation to the inside quote and the quotes of other market makers, and the ratio of executions to quote changes.<sup>14</sup> Accordingly, these PMM standards were suspended from February 3, 1997, through April 1, 1998,<sup>15</sup> during which time all market makers have qualified as PMMs and have been able to avail themselves of the PMM exemption to the NASD's short sale rule.<sup>16</sup>

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<sup>13</sup>Under the suspended PMM standards in NASD Rule 4612, which this proposal seeks to continue to suspend, a Nasdaq market maker is deemed to be a PMM if it meets two of three criteria: (1) the market maker maintained the best bid or best offer as shown on Nasdaq no less than 35% of the time; (2) a market maker maintained a spread no greater than 102% of the average dealer spread ("102% test"); and (3) no more than 50% of a market maker's quotation changes occurred without a trade execution. In addition, if a registered market maker meets only one of the above criteria, it nevertheless qualifies if the market maker accounts for volume at least 1½ times its proportionate share of overall volume in the stock.

<sup>14</sup>Specifically, the implementation of the Order Handling Rules raised the following concerns with the PMM standards in NASD Rule 4612: 1) it became impossible to tell when market maker quote changes were being driven by customer interests that are entered and then subsequently canceled without any execution, thus making it difficult for market makers to meet the 102% test; 2) the test regarding the percentage of time in which the market maker's quote was at the inside became less relevant because market maker quotes were driven to an extent by customer limit orders; and 3) SOES decrementation had a significant impact on individual market maker quotations as they could be decreased to zero and automatically refreshed at a designated price. See Securities Exchange Act Release No. 38294 (February 14, 1997) 62 FR 8289 (February 24, 1997) (order granting temporary accelerated approval of suspension of PMM standards).

<sup>15</sup>Id.; Securities Exchange Act Release No. 39198 (October 3, 1997) 62 FR 53365 (October 14, 1997) (order granting temporary accelerated approval of continuing suspension of PMM standards until April 1, 1998; File No. SR-NASD-97-73).

<sup>16</sup>This exemption to NASD Rule 3350 allows "qualified" market makers (i.e., PMMs) to sell short on a down bid (i.e., when the current bid is lower than the previous inside bid) when engaging in bona fide market making activity. See NASD Rule 3350(c)(1).

Since February 1997, the NASD and Nasdaq have worked to develop PMM standards that are more meaningful in an order-driven environment and better identify firms that are engaging in responsible market maker activity deserving of the benefits associated with being a PMM, such as being exempt from the short sale rule. The proposed PMM standards reward market makers that provide meaningful liquidity to the market based on the market makers' buying and selling activity in up and down markets and their relative buying and selling activity (in terms of share-volume and trading) in comparison to other market makers.

Specifically, to determine whether the market maker is a provider of liquidity, Nasdaq applies the net liquidity ratio ("NLR" or "NLR Test"). As explained below, a market maker must meet a certain numerical threshold to be considered a provider of liquidity, and thus "pass" the NLR threshold. Next, Nasdaq calculates a market maker's proportionate share of proprietary share-volume ("proportionate volume") and proportionate share of proprietary trades ("proportionate trades")<sup>17</sup> in a stock, and determines whether the market maker meets a certain numerical threshold for proportionate volume or a certain numerical threshold for proportionate trades (collectively, the "Proportionality Test").<sup>18</sup> If the market maker passes

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<sup>17</sup>A market maker's proportionate volume shall be determined by: dividing the market maker's total proprietary share-volume in a stock by all market maker proprietary share-volume for that stock; and then multiplying that ratio by the total number of registered market makers in the stock. A market maker's proportionate trades shall be determined by: dividing the market maker's total number of proprietary trades in a stock by the total number of proprietary trades by all market makers in that stock; and then multiplying that ratio by the total number of registered market makers in the stock. For example, if a market maker transacts 10% of the total proprietary share-volume in a stock with 10 registered market makers, the market maker's proportionate volume would be 1.0.

<sup>18</sup>The threshold for proportionate volume and proportionate trades shall be 1.0 for each. Accordingly, a market maker must account for at least one times its proportionate share of all share-volume in the stock or its proportionate share of all trades for the stock during the review period. For example, if during the review period a stock had 10 market

both the NLR and Proportionality Tests, the market maker qualifies as a PMM. As further described below, the proposed rule contains alternative approaches for stocks where the number of market makers meeting the NLR and Proportionality Tests is less than 50% of registered market makers and for stocks with fewer than eight registered market makers.

**NLR Test and Proportionality Test.** Under the NLR Test, Nasdaq first determines the direction of the market (*i.e.*, whether the market is “up” or “down”),<sup>19</sup> and then examines whether the market maker is engaging in liquidity-providing activity during up and down market periods. Specifically, a market maker will receive credit for all proprietary purchases in down markets, and all proprietary sales during up markets. The accumulated proprietary share-volume of these liquidity trades is divided by the total proprietary volume traded during up and down markets, excluding volume during neutral periods, sales at the inside offer during down markets, and purchases at the inside bid during up markets.<sup>20</sup> The NASD and Nasdaq believe that these trades demonstrate a positive liquidity contribution to the market; that is, the market maker is providing liquidity and market stabilization by buying during down markets (when there is significant selling interest), and by selling in up markets (when there is significant buying interest). The resulting number provides an NLR with a potential value between 0 and 1. An NLR of 1.0, for example, indicates that each transaction was done in a liquidity-providing, stabilizing manner.

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makers and had an overall share-volume of 1,000,000 shares and 15,000 trades, a market maker would have to transact one-tenth of all share-volume or trades -- 100,000 in share-volume or 1,500 trades.

<sup>19</sup>For the purposes of calculating NLR, the direction of the market is defined by looking at the five minute period prior to the trade report. If there has been no change in the bid

<sup>21</sup>For example, Stock X has 12 market makers. Market makers ABCD and EFGH attract a large percentage of order flow from institutions and account for 30% of the share-volume, but only 15 percent of the trades in the stock. Market makers QRST and UVWX attract a high percent of retail order flow and thus account for 30% of the trades, but account only for 15% of the share-volume of the stock. Each of these market makers provides liquidity to the market, and each would receive credit under the formula.

**50% Analysis.** If after the application of the NLR and Proportionality Tests, the number of firms earning PMM status is less than 50% of all registered market makers in a stock, Nasdaq will augment the number of PMMs using the following method. If there are market makers that meet the NLR Test but not the Proportionality Test (“Remaining Market Makers”), Nasdaq will calculate the number of market makers that will bring the total number of PMMs to 50% of all registered market makers in the stock.<sup>22</sup> (If there are no market makers that meet the NLR, Nasdaq will not apply the “50% Analysis” and will not augment the number of PMMs.) Nasdaq then will rank these Remaining Market Makers by proportionate volume, and will designate (from highest to lowest ranked) the Remaining Market Makers as PMMs until the total number of PMMs (i.e., those market makers that meet both the NLR and Proportionality Tests and the top-ranked Remaining Market Makers by proportionate volume) reaches a number not more than 50% of all registered market makers.<sup>23</sup> Nasdaq also will rank the Remaining Market Makers by proportionate trades, and will designate these Remaining Market Makers as PMMs until the total number of PMMs (i.e., those market makers that meet

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<sup>22</sup>For example, if Stock Q has 24 market makers, and 9 meet the NLR and Proportionality tests, there would be 3 open slots which could be filled when the Remaining Market Makers were ranked by volume and then by trades.

<sup>23</sup>The 50% levels shall be fixed and not subject to modification by Nasdaq, so that if a market maker meets the NLR threshold and falls within the top 50% of market makers when ranked by proportionate volume or the top 50% of market makers when ranked by proportionate trades, the market maker automatically shall be designated as a PMM. The only instance in which Nasdaq would designate PMMs in an amount less than 50% of all registered market makers, would be if less than 50% of the registered market makers achieve the NLR.

both the NLR and Proportionality Tests and the top-ranked Remaining Market Makers by proportionate trades) reaches a number not more than 50% of all registered market makers.<sup>24</sup>

**Securities with Eight or Fewer Market Makers.** If the number of market makers in a particular NNM security is eight or fewer, a market maker will earn PMM status by satisfying the NLR threshold only. Thus, for stocks with eight or fewer market makers, Nasdaq will consider neither volume nor trades in determining PMM status. The NASD and Nasdaq believe that this approach is appropriate because it makes the PMM status more attainable in these circumstances and gives firms an incentive to make markets in smaller or less widely-covered securities.

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<sup>24</sup>Under the 50% Analysis, the group of market makers designated as PMMs by volume and then by trades may not be the same, and thus the final number of PMMs may be more than 50% of the total number of market makers. Conversely, the number of PMMs may be less than 50% of all market makers because all PMMs must meet the NLR threshold. For example, Stock Q has 24 market makers, and 9 market makers are PMMs because they meet both the NLR and the Proportionality Test. If no other market maker (aside from the 9 PMMs) meet the NLR threshold, no other market makers will be designated as PMMs. If there are 3 or more market makers that meet the NLR, then these Remaining Market makers will be ranked by proportionate volume and then by proportionate trades and the top 3 from each of these two groups (which may or may not overlap in identity) will be designated as PMMs.



**Timing For Implementation of New PMM Standards.** As proposed, the new PMM standards will become effective May 1, 1998. The NASD and Nasdaq note that currently all market makers registered in a security are PMMs due to the suspension of the previous PMM standards, and will continue to be so designated on the pilot's proposed start date of May 1, 1998. The NASD and Nasdaq recognize that once the pilot begins on May 1, 1998, PMMs will not have the ability to avail themselves of the one-month look-back provision because there will be no meaningful trading to analyze prior to May 1, 1998. Thus, in order to give PMMs the full benefit of the one-month look-back period and to allow market makers time to adjust their trading activity to the new standards, the NASD and Nasdaq propose to implement the new standards so that no market maker that is designated as a PMM when the pilot begins on May 1, 1998, will lose its PMM status -- based on a failure to meet the new PMM standards -- until July 6, 1998. The NASD and Nasdaq believe that it is fair to give market makers this time to adjust their trading activity before they lose their PMM designation, particularly since PMM standards have been suspended for more than a year and since the new PMMs are more stringent than the previous standards.<sup>26</sup>

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<sup>26</sup>Subparagraph (f) of NASD Rule 4612 permits market makers to request reconsideration of a notice to withhold PMM designation based on a market maker's excused withdrawal status. The NASD and Nasdaq note that the rules governing withdrawals from market making (i.e., NASD Rules 4619, 4620, and 4730) recently were amended. See Securities Exchange Act Release No. 39423 (December 10, 1997) 62 FR 66160 (December 17, 1997). Furthermore, the NASD and Nasdaq recently submitted a rule proposal (SR-NASD-98-17) to implement a new order delivery and execution system to replace SelectNet and SOES. See Securities Exchange Act Release No. 39718 (March 4, 1998) 63 FR 12124 (March 12, 1998). If approved, this proposal also would amend the procedures relating to withdrawals for "SOES-ed out of the box" situations.

**Examples of Operation of Proposed PMM Standards.** Below are examples of how the proposed new PMM standards will operate:

**Example 1.** Stock WXYZ has six market makers. Four market makers achieve an NLR of at least .67 or above. Because WXYZ has less than eight market makers, all four of the market makers with an NLR of at least .67 will be designated as PMMs, regardless of their volume or trades.

**Example 2.** Stock ABCD has 20 market makers; 11 market makers achieve an NLR of at least .67 or above. Of those 11 market makers, six transact at least their proportional level of share-volume or trades. These six market makers automatically are designated as PMMs. Because the number of market makers that meet both the NLR and Proportionality Tests is less than 50% of the total number of registered market makers in ABCD, Nasdaq will rank the remaining market makers that have an NLR of at least .67 (five in total) according to their proportionate level of share-volume. The top four qualify, yielding a total of 10 PMMs (i.e., 50% of the total number of market makers). Next, the same five market makers are ranked according to their proportionate level of trades and the top four are designated as PMMs. In this example, the four market makers chosen by ranking by proportionate volume and the four market makers chosen by ranking by proportionate trades are the same. Thus, the final number of PMMs is 10, or 50% of the total number of registered market makers.

<b>Market Makers in Stock ABCD</b>	<b>NLR</b>	<b>Proportionate Volume</b>	<b>Proportionate Trades</b>	<b>PMM?</b>
Market Maker 1	.76	3.80	0.88	YES
Market Maker 2	.78	1.58	1.07	YES
Market Maker 3	.83	1.17	1.00	YES

Market Maker 4	.81	0.80	1.48	YES
Market Maker 5	.84	0.79	1.41	YES
Market Maker 6	.82	0.97	1.01	YES
Market Maker 7	.80	0.98	0.84	YES
Market Maker 8	.87	0.65	0.61	YES
Market Maker 9	.79	0.54	0.94	YES
Market Maker 10	.85	0.51	0.69	YES
Market Maker 11	.80	0.16	0.24	NO
Market Maker 12	.65	3.94	2.83	NO
Market Maker 13	.66	0.83	1.84	NO
Market Maker 14	.65	0.67	0.94	NO
Market Maker 15	.64	0.51	0.93	NO
Market Maker 16	.61	0.41	0.84	NO
Market Maker 17	.61	0.40	0.49	NO
Market Maker 18	.58	0.70	0.95	NO
Market Maker 19	.51	0.16	0.24	NO
Market Maker 20	.48	0.01	0.02	NO

**Example 3.** Stock IJKL has 19 market makers; 11 market makers have an NLR of .67 or better. Of those 11 market makers, six transact at least their proportional level of share-volume or trades. These six market makers automatically are designated as PMMs. Because the number of market makers that meet both the NLR and Proportionality Tests is less than 50% of the total number of registered market makers in IJKL, Nasdaq will rank the remaining market makers that have an NLR of at least .67 (five in total) according to their proportionate level of share-volume. The top four are designated as PMMs, thus yielding a total of 10 PMMs.<sup>27</sup> Next, the same five market makers are ranked according to their proportionate level of trades and the top four are designated as PMMs, thus yielding a total of 10 PMMs. Unlike Example 2, the four market makers chosen by ranking by proportionate volume and the four market makers chosen by ranking by proportionate trades are not the same. Three of the four market makers (i.e., market makers 7, 8, and 9, listed below) are the same; market maker 10, however, is designated as a PMM according to its proportionate volume and market maker 11 is designated a PMM according to its proportionate trades. Thus, the final number of PMMs is 11, or 55% of the total number of registered market makers.

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<sup>27</sup>This example illustrates that when there is an odd number of registered market makers, Nasdaq rounds up to calculate the “50%” level (i.e., 50% level = (number of market makers + 1)/ 2). That is, in example 3 where there are 19 registered market makers, Nasdaq would round up and would have 10 possible PMM slots when ranking by proportionate volume and would have 10 possible slots when ranking by proportionate trades (i.e.,  $(19 + 1)/2 = 10$ ).

<b>Market Makers in NLR Stock IJKL</b>		<b>Proportionate Volume</b>	<b>Proportionate Trades</b>	<b>PMM?</b>
Market Maker 1	.76	3.80	0.88	YES
Market Maker 2	.78	1.58	1.07	YES
Market Maker 3	.83	1.17	1.00	YES
Market Maker 4	.81	0.80	1.48	YES
Market Maker 5	.84	0.79	1.41	YES
Market Maker 6	.82	0.97	1.01	YES
Market Maker 7	.80	0.98	0.84	YES
Market Maker 8	.87	0.65	0.61	YES
Market Maker 9	.79	0.54	0.94	YES
Market Maker 10	.85	0.51	0.24	YES
Market Maker 11	.80	0.16	0.31	YES
Market Maker 12	.65	3.94	2.83	NO
Market Maker 13	.66	0.83	1.84	NO
Market Maker 14	.65	0.67	0.94	NO
Market Maker 15	.64	0.51	0.93	NO
Market Maker 16	.61	0.41	0.84	NO
Market Maker 17	.61	0.40	0.49	NO
Market Maker 18	.58	0.70	0.95	NO
Market Maker 19	.51	0.16	0.24	NO

**Example 4.** Stock EFGH has 18 market makers. Six of the 18 market makers meet both the NLR and Proportionality Tests. These six market makers automatically are designated as PMM. Because less than 50% of the total number of registered market makers in EFGH qualify as PMMs, Nasdaq would augment this number by the ranking process. Since, however, Market Maker 7 is the only remaining market maker that meets the NLR, only Market Maker 7 will be designated as a PMM. Thus, only 7 (or 38.9%) of the 18 registered market makers qualify as PMMs.

<b>Market Makers in NLR Stock EFGH</b>		<b>Proportionate Volume</b>	<b>Proportionate Trades</b>	<b>PMM?</b>
Market Maker 1	.76	3.80	0.88	YES
Market Maker 2	.68	1.58	1.07	YES

Market Maker 3	.73	1.17	1.00	YES
Market Maker 4	.71	1.00	1.48	YES
Market Maker 5	.84	1.02	1.41	YES
Market Maker 6	.72	1.21	1.01	YES
Market Maker 7	.67	0.91	0.84	YES
Market Maker 8	.66	0.65	1.01	NO
Market Maker 9	.65	0.54	0.94	NO
Market Maker 10	.65	0.51	0.69	NO
Market Maker 11	.65	0.16	0.24	NO
Market Maker 12	.65	3.94	2.83	NO
Market Maker 13	.65	0.83	1.84	NO
Market Maker 14	.65	0.67	0.94	NO
Market Maker 15	.64	0.51	0.93	NO
Market Maker 16	.61	0.41	0.84	NO
Market Maker 17	.61	0.40	0.49	NO
Market Maker 18	.58	0.70	0.95	NO

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**Extension of Suspension of Existing PMM and Extension of Short Sale Rule.**

In addition to proposing new PMM standards, the NASD and Nasdaq are proposing to extend the current suspension of the presently suspended PMM standards until the proposed PMM pilot program is implemented on May 1, 1998. This extension will allow for continuity in the market until the new PMM standards are phased in.

Additionally, as explained below, the NASD and Nasdaq are proposing to extend until November 1, 1998, the pilot of the Short Sale Rule including the market maker exemption to that rule and the amended definition of legal short sale.<sup>28</sup> The Short Sale Rule has been

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<sup>28</sup>The definition of "legal" short sale was amended on a pilot basis on September 26, 1997, and has been extended commensurate with the subsequent extensions of the Short Sale Rule pilot. See Securities Exchange Act Release No. 39139 (September 26, 1997) 62 FR 52169 (October 6, 1997)(initial temporary approval order for amendment to "legal" short sale); Securities Exchange Act Release No. 39551 (January 14, 1998) 63 FR 3370 (January 22, 1998) (extending amended legal short sale definition until April 15, 1998). This amendment provides that a "legal" short sale can be effected on a down bid: at a

operating on a pilot basis since June 29, 1994,<sup>29</sup> and most recently was extended until April 15, 1998.<sup>30</sup> On August 8, 1997, the NASD and Nasdaq submitted a proposal to implement the Short Sale Rule on a permanent basis.<sup>31</sup> Subsequent to submitting this request, the Commission instructed the NASD and Nasdaq that it would not determine whether to implement the Short Sale Rule on permanent basis until more meaningful PMM standards were developed and implemented. In response, the NASD and Nasdaq have proposed the standards described in this filing. Furthermore, the NASD and Nasdaq anticipate that under the proposed PMM standards, the number of market makers qualifying for PMM status will be reduced significantly from the levels under previous PMM standards. In order to minimize any unintended consequence of the more stringent PMM standards -- such as restricting market makers from "facilitating" customer orders or broker/dealers from executing riskless principal transactions (and effectively acting as agent) when they have a net short position -- the NASD and Nasdaq shortly will file a rule proposal to amend the Short Sale Rule to provide all market makers (not only PMMs) with an exemption to the Short Sale Rule to engage in customer-facilitating, liquidity-providing transactions.

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(continued. . .)

price of 1/16th above the bid when the inside spread is 1/16th or greater; or at a price equal to or greater than the offer price when the inside spread is less than 1/16th.

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

<sup>30</sup>See Securities Exchange Act Release No. 39551 (January 14, 1998) 63 FR 3370 (January 22, 1998).

<sup>31</sup>See Securities Exchange Act Release No. 38979 (August 26, 1997) 62 FR 46537 (September 3, 1997).

Accordingly, an extension of the Short Sale Rule is necessary to allow the NASD and Nasdaq to study the effects of the revised PMMs and the soon-to-be filed amendments to the Short Sale Rule, and to study the interaction between the revised PMM standards and the Short Sale Rule. At the end of the PMM pilot, it is expected that the NASD, Nasdaq, and the Commission will be in a better position to evaluate the efficacy of the revised PMM standards and to evaluate the proposal to permanently approve the Short Sale Rule.

### **Statutory Basis**

The NASD and Nasdaq believe that the proposed rule change is consistent with Sections 15A(b)(6) and 11A(a)(1)(C) of the Exchange Act. Among other things, Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and in general to protect investors and the public interest. Section 11A(a)(1)(C) provides that it is in the public interest and appropriate for the maintenance of fair and orderly markets to, among other things, assure the economically efficient execution of securities transactions and the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities, and to assure fair competition among brokers and dealers.

Specifically, the NASD and Nasdaq believe that the proposed PMM standards provide a meaningful measure of whether a market maker is providing liquidity to the market and thus deserving of an exemption to the NASD's Short Sale Rule. Furthermore, by sufficiently

restricting the number of market makers that may qualify for PMM status, the proposed standards foster competition among market makers and benefit investors. Similarly, the proposal protects investors by limiting the number of market makers that may sell short only to those who regularly effect liquidity-providing and stabilizing transactions. Furthermore, the temporary extension of the suspension of the presently suspended PMM standards until the new standards are in place and an extension of the pilot of the Short Sale Rule should provide market makers with certainty regarding whether they are entitled to an exemption under the rule and continuity of short sale regulation, thus promoting market efficiency and orderly markets during a transition period. The proposal should also help in reducing investor confusion at this time and thereby promote efficient and fair markets.

**B. Self-Regulatory Organization's Statement on Burden on Competition**

The NASD and Nasdaq believe 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 Exchange Act.

**C. 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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date

if it finds such longer period to be appropriate and publishes its reasons for so finding or

(ii) as to which the NASD consents, the Commission will:

- (A) by order approve such proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

The NASD and Nasdaq have requested that the Commission find good cause pursuant to Section 19(b)(2) for approving the extended suspension of the current PMM standards and the extension of the Short Sale Rule pilot prior to the 30th day after publication in the Federal Register. For the reasons discussed in Item V below, the Commission grants accelerated partial approval for these portions of the proposal.

#### **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 Exchange Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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-98-26 and should be submitted by (insert date 21 days from the date of publication).

V. **Commission's Findings and Order Granting Accelerated Partial Approval of the Proposed Rule Change**

After careful consideration, the Commission has concluded, for the reasons set forth below, that the extension of the Short Sale Rule pilot until November 1, 1998, and the extension of the current suspension of existing PMM standards through May 1, 1998, are consistent with the requirements of the Exchange Act and the rules and regulations applicable to the NASD. In particular, these extensions conform with the requirements of Section 15A(b)(6)<sup>32</sup> of the Exchange Act and the rules and regulations thereunder. Pursuant to Section 15A(b)(6), the NASD's rules must be designed, among other things, to prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade. The Commission believes that these portions of the proposal are consistent with Section 15A(b)(6) of the Exchange Act because extension of the Short Sale Rule pilot and continued suspension of the current PMM standards will maintain the status quo while the Commission and the NASD review the operation of the pilot program for new PMM standards. It is not unreasonable to maintain the NASD's Short Sale Rule for a further short period while the Commission evaluates the effect of new PMM standards on market maker behavior and use of the short sale exemption. Thus, because the Commission's ultimate stance on the Short Sale Rule may be affected, in part, by the operation of the proposed new PMM standards, it is reasonable to keep the Short Sale Rule in place while

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<sup>32</sup>15 U.S.C. § 78o-3(b)(6).

the pilot for new PMM standards commences. Furthermore, it is judicious, in the short term, to avoid reintroducing existing, potentially outdated PMM standards prior to the implementation of a new PMM pilot.

In finding that the extensions of the Short Sale Rule pilot and the suspension of the existing PMM standards are consistent with the Exchange Act, the Commission reserves judgment on the merits of the Short Sale Rule, any market maker exemptions, and the proposed new PMM standards. The Commission recognizes that the current Short Sale Rule already has generated significant public comment. Such commentary, along with any further comment on the interaction of the Short Sale Rule with the proposed new PMM standards, will help guide the Commission's evaluation of the Short Sale Rule and new PMM standards. Moreover, during this period, the Commission anticipates that the NASD will continue to address the Commission's questions and concerns and provide the Commission staff with additional information about the practical effects and the operation of the revised PMM standards and possible interaction between those standards and the NASD's Short Sale Rule.

The Commission finds good cause for approving the extension of the Short Sale Pilot and the extension of the suspension of existing PMM standards prior to the 30th day after the date of publication of notice of filing thereof. The Short Sale Rule has been in place since September 6, 1994, and the Commission is only extending it for six and a half months in order to evaluate its interaction with new PMM standards. In addition, as noted

above, it could be disruptive to market making to reintroduce outdated PMM standards for a brief period prior to implementation of a new PMM pilot.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Exchange Act,<sup>33</sup> that the portion of the proposed rule change (File No. SR-NASD-98-26) containing the extension of the NASD's Short Sale Rule pilot until November 1, 1998, and the suspension of existing PMM standards until May 1, 1998, is hereby approved on an accelerated basis.<sup>34</sup>

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>35</sup>

Jonathan G. Katz  
Secretary

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<sup>33</sup>15 U.S.C. § 78s(b)(2).

<sup>34</sup>In approving this portion of the proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. § 78c(f).

<sup>35</sup>17 CFR 200.30-3(a)(12).