

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50217; File No. SR-NASD-2004-092)

August 18, 2004

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Extension of Short Sale Rule and Continued Suspension of Primary Market Maker Standards Set Forth in Rule 4612

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on June 14, 2004, 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, II, and III below, which Items have been prepared by Nasdaq. On July 21, 2004, Nasdaq filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The proposed rule change, as amended, was filed by Nasdaq as a non-controversial filing, under Rule 19b-4(f)(6) of the Act.<sup>4</sup> 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

The Nasdaq Stock Market, Inc. (“Nasdaq”) is proposing to extend the pilot effectiveness

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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 Mary Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine England, Assistant Director, Division of Market Regulation, Commission, dated July 21, 2004 (“Amendment No. 1”). Amendment No. 1 notes the name change from “Nasdaq National Market Execution System” to “Nasdaq Market Center.”

<sup>4</sup> 17 CFR 240.19b-4(f)(6). For purposes of determining the effective date and calculating the sixty-day period within which the Commission may summarily abrogate the proposed rule change under Section 19(b)(3)(C) of the Act, the Commission considers that period to commence on July 21, 2004, the date Nasdaq filed Amendment No. 1. See 15 U.S.C. 78s(b)(3)(C).

of Rule 3350 until December 15, 2004. Nasdaq is also seeking to continue the suspension of the effectiveness of the Primary Market Maker ("PMM") standards currently set forth in Rule 4162 until December 15, 2004. If not extended, these pilot programs would expire on June 15, 2004. In addition, Nasdaq is seeking to extend the pilot effectiveness of the penny (\$0.01) legal short sale standard contained in paragraph (b)(2) of Interpretative Material 3350 ("IM-3350") until December 15, 2004. If not extended, this pilot program would expire on June 30, 2004.

The text of the proposed rule change is as follows. Additions are underlined; deletions are bracketed.<sup>5</sup>

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#### **NASD Rule 3350 Short Sale Rule**

(a) (1) **No Change.**

(2) With respect to trades executed on or reported to Nasdaq, no member shall effect a short sale for the account of a customer or for its own account in a Nasdaq National Market security at or below the current best (inside) bid displayed in the Nasdaq Market Center [National Market Execution System] when the current best (inside) bid is below the preceding best (inside) bid in the security.

(b) - (k) **No Change.**

(l) This section shall be in effect until [June 15, 2004] December 15, 2004.

#### **IM-3350 Short Sale Rule**

(a) **No Change.**

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<sup>5</sup> The proposed rule change is marked to show changes from the rule as it appears in the electronic NASD Manual available at [www.nasd.com](http://www.nasd.com).

(b) (1) **No Change.**

(2) With respect to trades executed on or reported to Nasdaq, Rule 3350 requires that no member shall effect a short sale for the account of a customer or for its own account in a Nasdaq National Market security at or below the current best (inside) bid displayed in the Nasdaq Market Center [National Market Execution System] when the current best (inside) bid is below the preceding best (inside) bid in the security. Nasdaq has determined that in order to effect a "legal" short sale when the current best bid is lower than the preceding best bid the short sale must be executed at a price of at least \$0.01 above the current inside bid when the current inside spread is \$0.01 or greater. The last sale report for such a trade would, therefore, be above the inside bid by at least \$0.01.

(c) **No Change.**

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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, 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 IV below. Nasdaq has prepared summaries, set forth in Sections A - 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

1. Purpose

**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. 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 SEC Rule 10a-1. On June 29, 1994, the SEC approved the NASD's short sale rule (the "Rule") applicable to short sales<sup>6</sup> in Nasdaq National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.<sup>7</sup> The NASD and the Commission have extended Rule 3350 numerous times, most recently, until June 15, 2004.

The Rule 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 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. The Rule is in effect from 9:30 a.m. until 4:00 p.m. each trading day.

In December of 2002, Nasdaq modified the method it uses to calculate the last bid by having it refer to the "Nasdaq Inside" which is comprised of quotations from all participants in Nasdaq Market Center execution systems, rather than referring to the National Best Bid and Offer ("NBBO"). Nasdaq currently calculates and applies the Nasdaq-based bid tick indicator to all trades executed by the Nasdaq Market Center. With respect to trades executed outside Nasdaq Market Center execution systems and reported to Nasdaq, Nasdaq participants have been

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<sup>6</sup> 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 200 of Regulation SHO, which is incorporated into Nasdaq's short sale rule by Rule 3350(k)(1).

<sup>7</sup> See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 26212 (July 7, 1994) ("Short Sale Rule Approval Order").

permitted to transition from the NBBO-based bid tick to the Nasdaq-based bid tick, provided that each firm select and apply a single bid tick indicator for all such trades executed by that firm. That transition has not been completed and, as explained below, in light of the Commission's adoption of Regulation SHO, Nasdaq has alerted members that it would not be prudent to transition from the NBBO bid tick to the Nasdaq bid tick at this time.

### **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 short sale rule is invoked, Rule 3350 provides an exemption for "qualified" market makers (*i.e.*, market makers that meet the PMM standards). Presently, Rule 4612 provides that a member registered as a market maker pursuant to Rule 4611 may be deemed a PMM if that member meets certain threshold standards. On February 14, 1997, the PMM standards were waived for all NNM securities due to the impact of the SEC's Order Handling Rules and corresponding NASD rule change and system modifications on the operation of the four quantitative standards.<sup>8</sup>

### **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 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

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<sup>8</sup> See Securities Exchange Act Release No. 38294 (February 17, 1997), 62 FR 8289 (February 24, 1997).

market, the Commission believes that regulation of short selling of Nasdaq National Market securities is consistent with the Act."<sup>9</sup> 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."<sup>10</sup> 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.<sup>11</sup> Through late 1999, Nasdaq represents that it 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. Reinstating the PMM standards set forth in Rule 4612 would be extremely

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<sup>9</sup> See Short Sale Rule Approval Order, *supra* note 7.

<sup>10</sup> *Id.*

<sup>11</sup> 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 does not yet require it; (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). Refer to Rule 11Ac1-4 of the Act for a further reading of the Limit Order Display Rule. 17 CRF 240.11Ac1-4.

disruptive to the market and harmful to investors.

### **Proposal to Extend Penny Short Sale Standard**

On March 2, 2001, the Commission approved, on a pilot basis,<sup>12</sup> Nasdaq's proposal to establish a \$0.01 above the bid standard for legal short sales in Nasdaq National Market securities as part of the Decimals Implementation Plan for the Equities and Options Markets. This pilot program has been continuously extended since that date and is currently set to expire on June 30, 2004.<sup>13</sup> Nasdaq now proposes to extend, through December 15, 2004, that pilot program. Extension until December 15, 2004 will allow the Nasdaq and the Commission to continue to evaluate the impact of the penny short sale pilot. If the instant filing is approved, Nasdaq will continue during the pilot period to require NASD members seeking to effect "legal" short sales when the current best (inside) bid displayed by Nasdaq is lower than the previous bid, to execute those short sales at a price that is at least \$0.01 above the current inside bid in that security. Nasdaq believes that continuation of this pilot standard appropriately takes into account the important investor protections provided by Rule 3350 and IM-3350 and the ongoing relationship of the valid short sale price amount to the minimum quotation increment of the Nasdaq market (currently also \$0.01).

#### 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section

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<sup>12</sup> See Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001).

<sup>13</sup> See Securities Exchange Act Release No. 47970 (June 3, 2003), 68 FR 34689 (June 10, 2003).

15A of the Act,<sup>14</sup> in general and with Section 15A(b)(6) of the Act,<sup>15</sup> in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, remove impediments to a free and open market and a national market system, and, in general, to protect investors and the public interest.

B. 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.

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

The foregoing rule change, as amended, has been filed by Nasdaq pursuant to Section 19(b)(3)(A) of the Act<sup>16</sup> and subparagraph (f)(6) of Rule 19b-4 thereunder.<sup>17</sup> Nasdaq has designated the proposed rule change as one that: (i) does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate. Therefore, the foregoing rule change, as amended, has become effective pursuant to Section 19(b)(3)(A) of the Act<sup>18</sup> and Rule 19b-4(f)(6) thereunder.<sup>19</sup> Nasdaq requests that the Commission waive both the 5-day notice and 30-day pre-operative

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<sup>14</sup> 15 U.S.C. 78o-3.

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

<sup>16</sup> 15 U.S.C. 78s(b)(3)(A).

<sup>17</sup> 17 CFR 240.19b-4(f)(6).

<sup>18</sup> See supra note 16.

<sup>19</sup> See supra note 17.

requirements contained in Rule 19b-4(f)(6)(iii).<sup>20</sup> Nasdaq believes good cause exists to grant such waivers because of the importance of short sale regulation to the protection of investors and the fact that the pilot programs will each expire if not extended. Nasdaq will implement this rule change immediately.

The Commission believes that waiving the 5-day notice and 30-day pre-operative delay is consistent with the protection of investors and the public interest. The Commission believes that accelerating the operative date does not raise any new regulatory issues, significantly affect the protection of investors or the public interest, or impose any significant burden on competition. For these reasons, the Commission designates the proposed rule change as effective and operative immediately.

At any time within 60 days of the filing of a rule change pursuant to Section 19(b)(3)(A) of the Act, the Commission may summarily abrogate the rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

##### Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or

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<sup>20</sup> Under subparagraph (f)(6)(iii) of Rule 19b-4, the proposal may not become operative for 30 days after the date of its filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, and the self-regulatory organization must file notice of its intent to file the proposed rule change at least five business days beforehand. 17 CFR 240.19b-4(f)(6)(iii).

- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-092 on the subject line.

Paper comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-092. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-NASD-2004-092 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>21</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>21</sup> 17 CFR 200.30-3(a)(12).