

both WEC and WEPCo under section 3(a)(1) of the Act.

For the Commission, by the Division of Investment Management, pursuant to delegated authority.

**Jonathan G. Katz,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44497; File No. SR-NASD-98-26]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to Amendment No. 10 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Extension of Short Sale Rule and Continued Suspension of Primary Market Maker Standards

June 29, 2001.

On June 15, 2001, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, the Nasdaq Stock Market Inc. ("Nasdaq"), submitted to the Securities and Exchange Commission ("SEC" or "Commission"), 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> a proposed rule to change to: (1) Continue to suspend the current Primary Market Maker ("PMM") standards until March 1, 2002, and (2) extend the NASD's Short Sale Rule pilot until March 1, 2002 ("Amendment No. 10").<sup>3</sup> Amendment No. 10 to the proposed rule change, SR-NASD-96-28, is described in Items I and II below, which Items have been prepared by the Nasdaq. The Commission is publishing this notice and order to solicit comments on amendment No. 10 from interested persons and to approve the amendment on an accelerated basis.

<sup>1</sup> 15 U.S.C. 78s(b)(1).

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

<sup>3</sup> See letters from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Belinda Blaine, Associate Director, Division of Market Regulation ("Division"), Commission, dated June 14, 2001; and Mary Dunbar, Vice President, Nasdaq, to Anitra Cassas, Special Counsel, Division, dated June 29, 2001. The current suspension and extension would expire on June 30, 2001. See Securities Exchange Act Release No. 43368 (September 27, 2000), 65 FR 59478 (October 5, 2000)."

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

In the current amendment, Nasdaq is proposing to extend the Short Sale Rule pilot and the suspension of the existing PMM standards from June 30, 2001 until March 1, 2002. The proposed rule language, as amended, follows. Additions are italicized; deletions are bracketed.

NASD Rule 3350

(a)-(k) No Changes.

(l) This Rule shall be in effect until [June 30, 2001] *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 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 III below. Nasdaq 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

##### (1) Background on the NASD's Short Sale Rule

Section 10(a) of the Exchange Act<sup>4</sup> 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 of the Exchange Act.<sup>5</sup> On June 29, 1994, the Commission approved the NASD's short sale rule, Rule 3350 ("Short Sale Rule"), applicable to short sales<sup>6</sup> in Nasdaq

<sup>4</sup> 15 U.S.C. 78j(a).

<sup>5</sup> 17 CFR 240.10a-1.

<sup>6</sup> A short sale is a sale of a security the seller does not own or any sale which 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-3 of the Exchange Act, which is incorporated into Nasdaq's short sale rule by NASD Rule 3350(k)(1).

National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.<sup>7</sup> The NASD and the Commission have extended NASD Rule 3350 numerous times, most recently, until June 30, 2001.<sup>8</sup>

Nasdaq's short-sale rule employs a "bid" test rather than a tick test because Nasdaq trades are not necessarily reported to the tape in chronological order. Nasdaq's short sale 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 on 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.<sup>9</sup> The rule is in effect from 9:30 a.m. E.T. until 4 p.m. E.T. each trading day.

To reduce the compliance burdens on its members, Nasdaq's short sale rule also incorporates seven exemptions contained in Rule 10a-1 under the Exchange Act that are relevant to trading on Nasdaq.<sup>10</sup> In addition, in an effort to not constrain the legitimate hedging needs of options market makers, the NASD's short sale rule 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.

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

<sup>8</sup> See *supra*, note 3.

<sup>9</sup> In light of the industry conversion to decimal pricing, Nasdaq recently amended the increment standard for legal short sales from 1/16th to \$0.01. The Commission approved the amendment to IM-3350 on a pilot basis, ending March 1, 2002. Securities Exchange Act Release No. 44030 (March 2, 2001), 66 FR 14235 (March 9, 2001).

<sup>10</sup> 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, and 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 Short Sale 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 Exchange Act dealing with the liquidation of index arbitrage positions and an "international equalizing exemption" are equally applicable to the NASD's short sale rule. See NASD Rule 3350(f).

## (2) Background on the NASD's 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, NASD Rule 3350(c)(1) provides an exemption for "qualified" Nasdaq market makers (*i.e.*, market makers that meet the PMM standards). Presently, NASD Rule 4612 provides 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 NASD Rule 3350 has been in effect, there have been two methods used to determine whether a market maker is eligible for the PMM 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 without interruption were exempt from Rule 3350 for short sales in that security, provided the short sales were made in connection with bona fide market making activity ("the 20-day" test).<sup>11</sup> From February 1, 1996 until February 14, 1997, the "20-day" test was replaced with a four-part quantitative test known as the PMM standards.<sup>12</sup>

Beginning on February 14, 1997, the PMM standards were suspended 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>13</sup> For

<sup>11</sup> See Short Sale Rule Approval Order, *supra* note 7.

<sup>12</sup> *Id.* 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 1 1/2 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 re-qualify for designation as a PMM by satisfying the threshold standards in the next review period.

<sup>13</sup> See Securities Exchange Act Release Nos. 38294 (February 14, 1997), 62 FR 8289 (February 24, 1997) (order granting temporary accelerated approval of suspension of PMM standards until October 1, 1997; File No. SR-NASD-97-07); 39198 (October 3, 1997), 62 FR 53365 (October 14, 1997) (order granting temporary accelerated approval of continuing suspension until April 1, 1998; File No. SR-NASD-97-73); 39819 (March 30, 1998), 63 FR 16841 (April 6, 1998) (order granting temporary

example, 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.<sup>14</sup> In light of those comments, Nasdaq staff convened an advisory subcommittee to develop PMM standards ("Subcommittee") in August 1998. The Subcommittee met nine times and formulated new PMM standards. On December 9, 1998, the NASD/Nasdaq staff met with the Commission staff and the Subcommittee to receive informal feedback on the new PMM standards. 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 suggested 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 suggested revisions, and concluded that the

accelerated approval of continuing suspension until May 1, 1998; File No. SR-NASD-98-26); 39936 (April 30, 1998); 63 FR 25253 (May 7, 1998) (order granting temporary accelerated approval of continuing suspension until July 1, 1998; Amendment No. 3 to File No. SR-NASD-98-26); 40140 (June 26, 1998), 63 FR 36464 (July 6, 1998) (order granting temporary accelerated approval of continuing suspension until October 1, 1998; Amendment No. 4 to File No. SR-NASD-98-26); 40485 (September 25, 1998), 63 FR 52780 (October 1, 1998) (order granting temporary accelerated approval of continuing suspension until March 31, 1999; Amendment No. 5 to File No. SR-NASD-98-26); 41195 (March 19, 1999), 64 FR 14778 (March 26, 1999) (order granting temporary accelerated approval of continuing suspension until June 30, 1999; Amendment No. 6 to File No. SR-NASD-98-26); 41568 (June 28, 1999), 64 FR 36416 (July 6, 1999) (order granting temporary accelerated approval of continuing suspension until December 31, 1999; Amendment No. 7 to File No. SR-NASD-98-26); 42219 (December 9, 1999), 64 FR 70753 (December 17, 1999) (granting temporary accelerated approval of continuing suspension until September 30, 2000; Amendment No. 8 to File No. SR-NASD-98-26).

<sup>14</sup> See Securities Exchange Act Release 39819 (March 30, 1998), 63 FR 16841 (April 6, 1998).

Commission's modified standards produced unfavorable results.<sup>15</sup>

The Commission notes that it intends to propose amendments to Rule 10a-1 under the Exchange Act, which applies to exchanges. The Commission recently noticed for public comment Nasdaq's application for registration as a national securities exchange under Section 6 of the Exchange Act.<sup>16</sup>

## (3) Current Amendment

Nasdaq believes that it is in the best interest of investors to extend the short sale regulation pilot program. In the Short Sale Approval Order, 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."<sup>17</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>18</sup> Nasdaq believes the benefits that the Commission recognized when it first approved NASD Rule 3350 apply with equal force today.

Similarly, Nasdaq believes 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 to avoid frustrating operation of the Commission's Order Handling Rules, in light of market factors that were not apparent at the time the Order Handling Rules were implemented.<sup>19</sup> Nasdaq has worked to

<sup>15</sup> See letter from John F. Malitzis, Assistant General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division, Commission, dated September 27, 1999.

<sup>16</sup> See Securities Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001).

<sup>17</sup> See Short Sale Rule Approval Order, *supra* note 8.

<sup>18</sup> *Id.*

<sup>19</sup> Nasdaq stated at the time that it believed the 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). See Securities Exchange Act Release No. 38294 (February 14, 1997), 62 FR 8289 (February 24, 1997).

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 have been unable to establish satisfactory PMM standards. Nasdaq believes that reinstating the PMM standards set forth in NASD Rule 4612 would be extremely disruptive to the market and harmful to investors.

Nasdaq also notes that the Commission has signaled to the securities industry that it is considering fundamental changes to Rule 10a-1 of the Exchange Act that could impact the manner in which Nasdaq and the other markets regulate short sales. On October 20, 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.<sup>20</sup> Nasdaq believes it would be inappropriate for Nasdaq to alter its regulation of short sales while the Commission is considering changing Rule 10a-1.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment No. 10, including whether the proposed Amendment 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 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 July 30, 2001.

<sup>20</sup> See Securities Exchange Act Release No. 42037 (October 20, 1999), 64 FR 57996 (October 28, 1999).

### 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 March 1, 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)<sup>21</sup> 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.

The Commission finds that continuation of the Short Sale Rule pilot and the continued suspension of the current PMM standards will maintain the status quo while the Commission is considering amending Rule 10a-1 under the Exchange Act. However, this extension of the pilot and continued suspension of the current PMM standards is subject to modification or revocation should the Commission amend Rule 10a-1 in such a manner as to deem the extension or suspension unnecessary or in conflict with any adopted amendments.<sup>22</sup>

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 be disruptive to the Nasdaq market and confusing to market participants to reintroduce the previous PMM standards while new PMM standards are being developed, and while the Commission is considering amending Rule 10a-1 under the Exchange Act.

*It Is Therefore Ordered*, pursuant to Section 19(b)(2) of the Act,<sup>23</sup> that Amendment No. 10 to the proposed rule change, SR-NASD-98-26, which extends the NASD Short Sale Rule pilot and the suspension of the current PMM standards to March 1, 2002, is approved on an accelerated basis.<sup>24</sup>

<sup>21</sup> 15 U.S.C. 78o-3(b)(6).

<sup>22</sup> Absent an exemption, Rule 10a-1 of the Exchange Act would apply to Nasdaq upon Commission approval of their exchange registration.

<sup>23</sup> 15 U.S.C. 78s(b)(2).

<sup>24</sup> In approving Amendment No. 10, the Commission has considered its impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>25</sup>

**Jonathan G. Katz,**  
*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-44499; File No. SR-NASD-2001-14]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. To Modify Certain Initial and Continued Listing Standards on Nasdaq

June 29, 2001.

#### I. Introduction

On March 8, 2001, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4<sup>2</sup> thereunder, a proposal to modify certain initial and continued listing standards on Nasdaq. Nasdaq also requested that the Commission grant accelerated approval for a pilot program that would give certain of the proposed new listing standards immediate effectiveness. On April 26, 2001, Nasdaq submitted Amendment No. 1 to the proposal.<sup>3</sup> On May 1, 2001, the Commission published notice of the proposal in the **Federal Register** and approved the proposed pilot program on an accelerated basis.<sup>4</sup> The Commission received one comment on the proposal. This order approves the proposed rule change and Amendment No. 1.

#### II. Description of the Proposal

Nasdaq proposed to amend NASD Rules 4200, 4310, 4320, 4420, and 4450 and thereby to modify certain quantitative initial and continued listing

<sup>25</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

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

<sup>3</sup> See Letter from Sara Nelson Bloom, Associate General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission (April 25, 2001). In Amendment No. 1, Nasdaq provided a chart that clarifies the proposed schedule for implementing the new listing standards and made certain technical corrections to the proposal.

<sup>4</sup> See Securities Exchange Act Release No. 44243 (May 1, 2001), 66 FR 23285 (May 8, 2001).