

(a)–(k) No Change.

(l) This section shall be in effect until December 15, 2003 [June 15, 2003]].

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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 III 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

1. Purpose

Background and Description of the NASD's Short Sale Rule

Section 10(a) of the Act⁵ 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 Act.⁶ On June 29, 1994, the Commission approved the NASD's short sale rule (the "Rule") applicable to short sales⁷ in Nasdaq National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.⁸ The NASD and the Commission have extended NASD Rule 3350 numerous times, most recently, until June 15, 2003.

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 (including bids for exchanges trading Nasdaq securities on an unlisted trading privileges basis), and disseminates symbols to denote whether the current inside bid is an "up-bid" or a "down-bid." To effect a "legal" short sale on a down-bid, the short sale must be executed at a price at least \$.01 above the current inside bid. The Rule is in effect from 9:30 a.m. until 4 p.m. each trading day.

To reduce the compliance burdens on its members, the Rule also incorporates seven exemptions contained in Rule 10a–1 of the Act,⁹ and other exemptions that are relevant to trading on Nasdaq.¹⁰ For example, in an effort to not constrain the legitimate hedging needs of options market makers, the Rule also contains a limited exception for standardized options market makers. The Rule also contains an exemption for warrant market makers similar to the one available for options market makers.

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, NASD Rule 3350 provides an exemption for "qualified" market makers (*i.e.*, market makers that meet the PMM standards). NASD Rule 4612 provides that a member registered as a market maker pursuant to NASD Rule 4611 may be deemed a PMM if that member meets certain threshold standards.

Since the Rule has been in effect, Nasdaq has used three methods to determine whether a market maker is eligible for the market maker exemption. Specifically, from September 4, 1994 through February 1, 1996, Nasdaq market makers that maintained a quotation in a particular NNM security

for 20 consecutive business days without interruption were exempt from the Rule for short sales in that security, provided the short sales were made in connection with bona fide market making activity ("the 20-day" test). From February 1, 1996 until the February 14, 1997, the "20-day" test was replaced with a four-part quantitative test known as the PMM standards.¹¹

On February 14, 1997, the PMM standards were waived for all NNM securities due to the impacts of the Commission's Order Handling Rules and corresponding NASD rule change and system modifications on the operation of the four quantitative standards.¹² For example, among other impacts, 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 Nasdaq Market Makers have been deemed to be PMMs.

In March 1998, Nasdaq proposed PMM standards that received substantially negative comments.¹³ In light of those comments, Nasdaq staff convened an advisory subcommittee to develop new PMM standards ("Subcommittee") in August 1998. The Subcommittee met nine times and formulated new PMM standards. NASD/Nasdaq staff requested to meet with the Commission staff and the Subcommittee to receive informal feedback on the new PMM standards. This meeting occurred on December 9, 1998. At the conclusion of the meeting, Commission staff noted the progress made by the Subcommittee and requested time to digest and more carefully analyze the proposed new PMM standards.

On July 29, 1999, members of the Nasdaq staff conducted a conference

¹¹ 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 or trading; or (4) the market maker executes 1½ times its "proportionate" volume in the stock. If a PMM did not satisfy the threshold standards after a particular review period, the market maker lost its designation as a PMM (*i.e.* the "P" next to its market maker identification was removed). Market makers could re-qualify for designation as a PMM by satisfying the threshold standards in the next review period.

¹² See Securities Exchange Act Release No. 38294 (February 17, 1997), 62 FR 8289 (February 24, 1997), (SR–NASD–97–07).

¹³ See Securities Exchange Act Release No. 39819 (March 30, 1998), 63 FR 16841 (April 6, 1998), (SR–NASD–97–73).

⁵ 15 U.S.C. 78j.

⁶ 17 CFR 240.10a–1.

⁷ A short sale is a sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller. To determine whether a sale is a short sale members must adhere to the definition of a "short sale" contained in Rule 3b–3 of the Act, which is incorporated into Nasdaq's short sale rule by NASD Rule 3350(k)(1).

⁸ See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994), (SR–NASD–92–12), ("Short Sale Rule Approval Order").

⁹ 17 CFR 240.10a–1.

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