

call with members of the Commission staff to receive feedback on the PMM standards that Nasdaq presented at the December 9, 1998 meeting. During the meeting, the Commission staff requested that Nasdaq modify several of the proposed standards and analyze the impact of those modifications on the primary market maker determination. On September 27, 1999, Nasdaq reported that the NASD Economic Research staff had analyzed data based on the Commission's recommended revisions, and concluded that the Commission's modified standards produced unfavorable results. Nasdaq requested that the Commission comment on the outcome of this test "as we intend to communicate your comments to the Subcommittee in an effort to resume the process of developing new standards."<sup>14</sup>

Nasdaq suspended development of PMM standards in late-1999 after the Commission signaled to the securities industry that it is considering fundamental changes to Rule 10a-1 of the Act,<sup>15</sup> changes that could impact the manner in which Nasdaq and the other markets regulate short sales. In October 1999, the Commission issued a Concept Release on Short Sales in which it sought comment on, among other things, revising the definition of a short sale, extending short sale regulation to non-exchange listed securities, and eliminating short sale regulation altogether. Nasdaq believed that it would be inappropriate for Nasdaq to dramatically alter its regulation of short sales while the Commission is considering fundamentally changing Rule 10a-1 of the Act.<sup>16</sup> At the request of the Division, Nasdaq has resumed development of PMM standards and has been working with the Commission staff towards that goal.

#### *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,<sup>17</sup> 15A(b)(6),<sup>18</sup> 15A(b)(9),<sup>19</sup> and 15A(b)(11)<sup>20</sup> of the Act. Specifically, the Commission stated that,

"recognizing the potential for problems associated with short selling, the changing expectations of Nasdaq market participants and the competitive disparity between the exchange markets and the OTC market, the Commission believes that regulation of short selling of Nasdaq National Market securities is consistent with the Act."<sup>21</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>22</sup> The benefits that the Commission recognized when it first approved NASD 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>23</sup> Through late-1999, Nasdaq worked diligently to address those concerns to the Commission's satisfaction, including convening a special subcommittee on PMM issues, proposing two different sets of PMM standards, and being continuously available and responsive to Commission staff to discuss this issue. Despite these efforts, the Commission and Nasdaq were unable to establish satisfactory PMM standards. At the request of Commission staff, Nasdaq has begun developing PMM standards suitable to today's rapidly changing marketplace. Re-instating the PMM standards set forth in NASD Rule 4612 would be extremely disruptive to the market and harmful to investors.

#### 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of section 15A of the Act,<sup>24</sup> in general and with section 15A(b)(6) of the Act,<sup>25</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*

The Nasdaq does not believe that the proposed rule change will impose any burden on competition.

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

The Nasdaq neither solicited nor received written comments with respect to the proposed rule change.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-98-26 and should be submitted by July 14, 2003.

### IV. Commission's Findings and Order Granting Accelerated Approval of Proposed Rule Change as a Pilot Program

After careful consideration, the Commission finds, for the reasons set forth below, that the extension of the Short Sale Rule Pilot until December 15, 2003, and the suspension of the existing PMM standards until December 15, 2003, are consistent with the requirements of the Act and the rules and regulations thereunder. In particular, the extension is consistent

<sup>14</sup> See Letter, dated September 27, 1999 from John F. Malitzis, Assistant General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division of Market Regulation, Commission.

<sup>15</sup> 17 CFR 240.10a-1.

<sup>16</sup> 17 CFR 240.10a-1.

<sup>17</sup> 15 U.S.C. 78k-1.

<sup>18</sup> 15 U.S.C. 78o-3.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> See Short Sale Rule Approval Order, *supra* note 8.

<sup>22</sup> *Id.*

<sup>23</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 did 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 NASD Rule 4612(g)(2)(B).

<sup>24</sup> 15 U.S.C. 78o-3.

<sup>25</sup> 15 U.S.C. 78o-3(6).