

to the closing price of the security.¹⁴⁶ Absent relief, such short sales could violate Rule 10a-1, in that the matching price (the closing price) of a security could be on a minus or zero-minus tick with respect to the last sale in the consolidated transaction reporting system. In granting this conditional relief, we have noted that short sale transactions executed at the closing price generally do not represent the type of abusive practices that Rule 10a-1 is designed to prevent. In particular, short sale orders entered in the after-hours crossing sessions cannot influence the matching price, but rather are priced by unrelated order flow and transactions occurring during the primary trading session, which are subject to the tick test. The relief previously granted under 10a-1 would continue to apply to cover exemptions from the price test provisions of Rule 201 of Regulation SHO.

Q. Do closing price transactions create perverse incentives for broker-dealers, such that they should not be granted an exception?

Q. Should the relief be codified as an exception to proposed Rule 201 of Regulation SHO?

VIII. Market Maker Exception From Proposed Uniform Bid Test

It has been argued that short selling by market makers helps offset imbalances in the supply and demand or gaps in the flow of buy and sell orders.¹⁴⁷ NASD Rule 3350 exempts from operation of the NASD's bid test short sales executed by qualified market makers in connection with bona fide market making.¹⁴⁸ There is currently no similar exception in Rule 10a-1, however, for the bona fide market making activities of specialists and third market makers in exchange-listed securities.

The chief reason advanced in support of the NASD market maker exception is that it enhances liquidity by permitting market makers to adjust inventory positions quickly.¹⁴⁹ If market makers were required to wait for an upbid to make a short sale, it is asserted that their ability to satisfy their market making functions would be impaired. The NASD has also argued that market makers perform an important market stabilizing function. According to a 1997 study by NASD Economic Research, market makers provide immediate, stabilizing liquidity.¹⁵⁰ If there is heavy selling pressure by investors and the market is moving down, market makers provide stability by standing ready to buy stock. According to the study, application of a short sale rule to market makers could reduce a market maker's ability to adjust inventory positions quickly, thereby reducing its supply of immediate liquidity to the marketplace.¹⁵¹ The NASD study also states that application of the short sale rule to market makers could increase market makers' costs, which would be passed on to investors in the form of wider spreads.¹⁵²

We do not find these arguments persuasive in the context of the proposed uniform bid test. In providing liquidity to customers, a market maker primarily buys at the bid and sells at the offer, or in between the bid and offer. We believe that a market maker should rarely need to sell short at or below the bid in its market making capacity.¹⁵³ The proposed rule permits unrestricted short sales at the offer or at any other price that is one cent or more above the bid, and thus the need for an exception to allow market makers to sell at or below the best bid seems limited.¹⁵⁴

We are also concerned that the exception may be being used by entities that are not actually engaged in bona fide market making.¹⁵⁵ For example, some issuers and investors have argued that some market makers are relying on the exception to continuously sell short into the bid—an activity that, as mentioned above, we find inconsistent with bona fide market making. The Commission believes that for the rule to have its intended positive effect on the market, all market participants, including market makers, should be subject to the rule.¹⁵⁶

A market maker that is positioning inventory to profit from market moves would find it advantageous to be able to short into the bid, like any speculator. One of the historical goals of short sale regulation is to prevent short sellers from accelerating a declining market by exhausting all remaining bids at one price level, and causing successively lower prices to be established by long sellers.¹⁵⁷ If such a seller is able to exhaust the existing bids in a security with short sales, and is able to attract long sellers to the market, the goal of accelerating the price decline of a particular security would be accomplished. Another goal of short sale regulation is that long sellers should have the right to sell first in a declining market.

Nevertheless, we believe that the proposed exception that would allow broker-dealers to execute customer sales on a riskless principal basis by looking to the customer's position would provide broker-dealers with additional flexibility to facilitate customer

Commission amend Rule 10a-1 in such a manner as to deem the extension unnecessary or in conflict with any adopted amendments.

¹⁵⁵ As initially approved, only market makers that met the Primary Market Maker (PMM) standards set forth in NASD Rule 4612 were eligible for an exception from the short sale rule. These PMM standards were subsequently suspended for all National Market Securities due to the potential impact of the Order Handling Rules. See Securities Exchange Act Release No. 38294 (February 14, 1997), 62 FR 8289 (February 24, 1997). As such, all market makers are currently eligible to rely on the exception.

¹⁵⁶ When we first approved the NASD's bid test and market maker exception in 1994, we recognized that the exception could result in problems of the type that have been reported by commenters. The Commission stressed the importance of monitoring the need for and effect of the exception on an ongoing basis, stating that experience with the test "may raise issues that require reconsideration of some or all elements of the proposal." See Temporary Approval Order, *supra*, note 149. In particular, the Commission noted concerns that the market maker exception could create opportunities for abusive short selling. *Id.*

¹⁵⁷ Securities and Exchange Commission, Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., at 251 (1963).

¹⁴⁶ The relief is generally subject to the conditions that: (1) short sales of a security in the after-hours matching session shall not be effected at a price lower than the closing price of the security on its primary exchange; (2) persons relying on these exemptions shall not directly or indirectly effect any transactions designed to affect the closing price on the primary exchange for any security traded in the after-hours matching session; and (3) transactions effected in the after-hours matching session shall not be made for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security.

¹⁴⁷ See, e.g., Irving M. Pollack, *Short Sale Regulation of NASDAQ Securities* (1986), at 12.

¹⁴⁸ Rule 3350 (c) provides further that "transactions unrelated to normal market making activity, such as index arbitrage and risk arbitrage that are independent from a member's market making functions, will not be considered bona fide market-making activity." See NASD Rule 3350. NASD IM-3350 also contains language specifying what type of activity does not constitute bona fide market making. See, *supra* n. 42.

¹⁴⁹ See Securities Exchange Act Release No. 34277 (July 7, 1994), 59 FR 34885 (July 29, 1994) (order granting temporary approval of Rule 3350 for an eighteen-month period (Temporary Approval Order)).

¹⁵⁰ See D. Timothy McCormick and Bram Zeigler, *The Nasdaq Short Sale Rule: Analysis of Market Quality Effects and The Market Maker Exemption*, NASD Economic Research, (August 7, 1997) at 22-23.

¹⁵¹ *Id.* at 20.

¹⁵² *Id.*

¹⁵³ The NASD's 1997 study indicates that during a sample month in 1997, market maker short sales at or below the inside bid accounted for only 2.41% of their total share volume. *Id.* at 27.

¹⁵⁴ In approving the market maker exception, the Commission noted that we would review the exception to determine whether the bid-test and exceptions are practicable and necessary on an ongoing basis. See Temporary Approval Order, *supra*, n. 149. Most recently, we extended the Rule 3350 pilot, including the market maker exemption, until December 15, 2003. See Securities Exchange Act Release No. 48035 (June 16, 2003), 68 FR 37183 (June 23, 2003). We noted that the extension was subject to modification or revocation should the