

on the Nasdaq.<sup>8</sup> 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). Presently, 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, the 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.<sup>9</sup>

<sup>8</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 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 under 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.

<sup>9</sup> 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

On February 14, 1997, the PMM standards were waived for all NNM securities due to the impact of the Commission's Order Handling Rules and corresponding NASD rule change and system modifications on the operation of the four quantitative standards.<sup>10</sup> 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, the Nasdaq proposed PMM standards that received substantially negative comments.<sup>11</sup> 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 call with members of the Commission staff to receive feedback on the PMM standards that the Nasdaq presented at the December 9, 1998 meeting. During the meeting, the Commission staff requested that the Nasdaq modify several of the proposed standards and analyze the impact of those modifications on the primary market maker determination. On September 27, 1999, the 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. The Nasdaq requested that the Commission comment on the outcome of this test "as we intend to communicate your comments to the Subcommittee in an

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>10</sup> See Securities Exchange Act Release No. 38294 (February 17, 1997), 62 FR 8289 (February 24, 1997).

<sup>11</sup> See Securities Exchange Act Release No. 39189 (March 30, 1998), 63 FR 16841 (April 6, 1998).

effort to resume the process of developing new standards."<sup>12</sup>

The 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, changes that could impact the manner in which the 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. The Nasdaq believed that it would be inappropriate for the Nasdaq to dramatically alter its regulation of short sales while the Commission is considering fundamentally changing Rule 10a-1. At the request of the staff of the Division of Market Regulation, the 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.* The 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 market, the Commission believes that regulation of short selling of Nasdaq National Market securities is consistent with the Act."<sup>13</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>14</sup> The benefits that the Commission recognized when it first approved NASD Rule 3350 apply with equal force today.

The Nasdaq notes that the Commission has proposed Regulation SHO, a unified short sale rule that, if approved, would apply to Nasdaq-listed

<sup>12</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>13</sup> See Short Sale Rule Approval Order, *supra* note 2.

<sup>14</sup> *Id.*