

For the Commission by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39551; File No. SR-NASD-97-94]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Extending the Pilot Program of the NASD's Short Sale Rule and the Amendment to the Definition of "Legal" Short Sale

January 14, 1998.

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, notice is hereby given that on December 23, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to grant accelerated approval of the proposed rule change.

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

The NASD is proposing to extend until April 15, 1998, the pilot program of the NASD's short sale rule ("Rule") and the recently-approved amendment to the definition of "legal" short sale.<sup>3</sup> Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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<sup>1</sup> 15 U.S.C. § 78s(b)(1) (1994).

<sup>2</sup> 17 CFR 240.19b-4 (1997).

<sup>3</sup> The NASD has requested permanent approval of its short sale rule. Securities Exchange Act Release No. 38979 (Aug. 26, 1997), 62 FR 46537 (Sept. 3, 1997) [File No. SR-NASD-97-58]. In response to its solicitation of comments on the filing (SR-NASD-97-58), the Commission has received 352 comment letters to date, which will be considered in connection with the Commission's determination on SR-NASD-97-58.

#### NASD Rule 3350

(1) This section shall be in effect until April 15, 1998 [January 15, 1998].

\* \* \* \* \*

#### 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 V 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 and Description of the NASD's Short Sale Rule

On June 29, 1994, the SEC approved the rule applicable to short sales<sup>4</sup> in Nasdaq National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.<sup>5</sup> The termination date for the pilot program for the Rule was subsequently extended until January 15, 1998.<sup>6</sup>

The Rule prohibits member firms from effecting short sales at or below the current inside bid as disseminated by Nasdaq whenever that bid is lower than the previous inside bid.<sup>7</sup> The Rule is in

<sup>4</sup> A short sale is a sale of a security which 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 Act, which rule is incorporated into Nasdaq's Rule by NASD Rule 3350(k)(1).

<sup>5</sup> Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994) [File No. SR-NASD-92-12] ("Short Sale Rule Approval Order").

<sup>6</sup> The Rule was extended on several occasions. See Securities Exchange Act Release No. 39140 (Sept. 26, 1997), 62 FR 52170 (Oct. 6, 1997) [File No. SR-NASD-97-65]; Securities Exchange Act Release No. 37917 (Nov. 1, 1996), 61 FR 57934 (Nov. 8, 1996) [File No. SR-NASD-96-41]; Securities Exchange Act Release No. 36171 (Aug. 30, 1995), 60 FR 46651 (Sept. 7, 1995) [File No. SR-NASD-95-35]. The most recent extension of the pilot program through January 15, 1998, was to allow Nasdaq and the NASD to develop more meaningful primary market maker standards.

<sup>7</sup> Nasdaq calculates the inside bid or best bid from all market makers in the security (including bids on behalf of 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." Specifically, an "up bid" is denoted by a green "up" arrow and a "down bid" is denoted by a red "down" arrow. To

effect during normal domestic market hours (9:30 a.m. to 4:00 p.m., Eastern Time). To ensure that market maker activities that provide liquidity and continuity to the market are not adversely constrained when the Rule is invoked, the Rule provides an exemption to "qualified" Nasdaq market makers (*i.e.*, those market makers that meet the Primary Market Maker ("PMM") standards). Even if a market maker is able to avail itself of the qualified market maker exemption, it can only utilize the exemption from the Rule for transactions that are made in connection with bona fide market making activity. If a market maker does not satisfy the requirements to be a qualified market maker, it can remain a market maker in the Nasdaq system, although it can not take advantage of the exemption from the Rule.

Since the Rule has been in effect, there have been three methods used 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 who 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 that short sales were made in connection with bona fide market making activity (the "20-day" test). From February 1, 1996 until February 14, 1997, the "20-day" test was replaced with a four-part quantitative test known as the Nasdaq PMM Standards.<sup>8</sup> On February 14, 1997, the PMM standards were waived for all NNM securities due to the effects of the SEC's Order Handling Rules and corresponding NASD rule change and system modifications on the operation of the

effect a "legal" short sale on a down bid, the short sale must be executed at a price at least a 1/16th of a point above the current inside bid. Conversely, if the security's symbol has a green "up" arrow next to it, members can effect short sales in the security without any restrictions.

<sup>8</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 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 requalify for designation as a PMM by satisfying the threshold standards in the next review period.

four quantitative standards.<sup>9</sup> For example, among other effects, the requirement that market makers display customer limit orders adversely affected the ability of market makers to satisfy the "102% Average Spread Standard."

Furthermore, in an effort to not constrain the legitimate hedging needs of options market makers, the 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. The Rule also incorporates seven exemptions contained in Rule 10a-1 under the Act ("Rule 10a-1") that are relevant to trading on Nasdaq.<sup>10</sup>

## 2. Proposal to Extend the Short Sale Rule

When the Commission approved the Rule on a temporary 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 NNM securities is consistent with the Act."<sup>11</sup> In addition, the Commission stated that it "believes that the NASD's short sale bid-test, including the market maker exemption, is a reasonable approach to short sale regulation of Nasdaq National Market securities and reflects the realities of its market structure."<sup>12</sup> However, in light of the Commission's concerns with adverse comments made about the Rule and the Commission's own concerns with the structure and impact of the Rule,<sup>13</sup> the

Commission determined to approve the Rule on a temporary basis to afford the NASD and the SEC an opportunity to study the effects of the Rule and its exemptions.<sup>14</sup> To address these concerns, in July 1996 and in August 1997, the NASD's Economic Research Department prepared two separate studies on the economic impact of the Rule, which concluded, among other things, that the Rule had no adverse impact on the market.<sup>15</sup> Accordingly, on August 8, 1997, the NASD submitted a proposed rule change that requested permanent approval of the Rule.<sup>16</sup> Additionally, on August 14, 1997, the NASD and Nasdaq submitted a proposed rule change to amend the definition of "legal" short sale in the Rule.<sup>17</sup>

On September 26, 1997, the Commission approved an extension of the Rule until January 15, 1998, to allow Nasdaq, to develop, and receive the

letters on the proposal, with 275 comments opposed to the Rule and 122 comments in favor of the Rule. Those commenters opposed to the Rule argued that: (1) the NASD had failed to provide sufficient evidence of the need for the Rule or demonstrate the appropriateness of the Rule based on a "bid" test instead of "tick" test; (2) the PMM standards will have negative effects on both market makers and the Nasdaq market; and (3) the Rule is inconsistent with the requirements of the Act.

<sup>14</sup> In particular, before considering any NASD proposal to extend, modify, permanently implement or terminate the Rule, the Commission requested that the NASD examine: (1) the effects of the Rule on the amount of short selling; (2) the length of time that the Rule is in effect (*i.e.*, the duration of down bid situations); (3) the amount of non-market maker short selling permitted under the Rule; (4) the extent of short selling by market makers exempt from the Rule; (5) whether there have been any incidents of perceived "abusive short selling"; (6) the effects of the Rule on spreads and volatility; (7) whether the behavior of bid prices has been significantly altered by the Rule; and (8) the effect of permitting short selling based on a minimum increment of  $\frac{1}{16}$ th.

<sup>15</sup> In July 1996, the NASD's Economic Analysis Department completed a study on the economic impact of the Rule, which concluded that the Rule has had no adverse impact on the market. The Economic Impact of the Nasdaq Short Sale Rule, NASD Economic Research Department (July 23, 1996) ("July 1996 Short Sale Study"). In the same month, NASD submitted a proposal to adopt the Rule on a permanent basis. Securities Exchange Act Release No. 37942 (July 29, 1996), 61 FR 40693 (Aug. 5, 1996) [SR-NASD-96-30]. Because the NASD believed additional quantitative analysis was necessary to evaluate the effects of the Rule, the NASD withdrew this rule filing. In August 1997, the NASD's Economic Analysis Department completed a second study on the economic impact of the Rule, which further concluded that the Rule has had no adverse impact on the market. The Nasdaq Stock Market Short Sale Rule: Analysis of Market Quality Effects and The Market Maker Exemption, NASD Economic Research Department (August 7, 1997) ("August 1997, Short Sale Study").

<sup>16</sup> Securities Exchange Act Release No. 38979 (Aug. 26, 1997), 62 FR 46537 (Sept. 3, 1997) [File No. SR-NASD-97-58].

<sup>17</sup> Securities Exchange Act Release No. 38975 (Aug. 26, 1997), 62 FR 46535 (Sept. 3, 1997) [File No. SR-NASD-97-59].

required board approval for, more meaningful PMM standards.<sup>18</sup> On the same day, the Commission also approved on a temporary basis until January 15, 1998, the proposed amendment to the definition of "legal" short sale.<sup>19</sup> During its September 1997 meeting, the Nasdaq Board of Directors approved revised PMM standards, which were forwarded to, and approved by, the NASD Board of Governors at its October 9, 1997 meeting.

The NASD has had ongoing discussions with Commission staff regarding the PMM standards. In light of the foregoing, the NASD and Nasdaq are requesting an extension of the Rule until April 15, 1998. The extension of time also will allow the NASD and Nasdaq to provide Commission staff with additional information about the practical effects and the operation of the revised PMM standards, and to explore other options to PMM standards, such as a customer facilitation exemption for market makers. The NASD and Nasdaq also are requesting an extension to April 15, 1998, of the amendment to the definition of "legal" short sale, which previously was approved on a temporary basis until January 15, 1998.

The NASD believes the proposed rule change is consistent with Section 25A(b)(6) of the Act because the Rule is premised on the same anti-manipulation and investor protection concerns that underlie the SEC's own short sale rule, Rule 10a-1 under the Act. In particular, as with Rule 10a-1, the NASD believes its Rule promotes just and equitable principles of trade by permitting long sellers access to market prices at any time, while constraining the execution of potentially abusive and manipulative short sales at or below the bid in a declining market. In addition, as with Rule 10a-1, Nasdaq believes its Rule removes impediments to a free and open market for long sellers and helps to assure liquidity at bid prices that might otherwise be usurped by short sellers. Lastly, because the immediate beneficiaries of the Rule are shareholders of NNM companies, Nasdaq believes its Rule is designed to protect investors and the public interest. At the same time, given that the Rule does not constrain short sales in a raising market or prohibit the execution

<sup>18</sup> See Securities Exchange Act Release No. 39140 (Sept. 26, 1997), 62 FR 52170 (Oct. 6, 1997) [File No. SR-NASD-97-65].

<sup>19</sup> Securities Exchange Act Release No. 39139 (Sept. 26, 1997), 62 FR 52169 (Oct. 6, 1997) [File No. SR-NASD-97-59]. The amendment provides that a "legal" short sale can be effected on a down bid: at a price of  $\frac{1}{16}$ th above the bid when the inside spread is  $\frac{1}{16}$ th or greater; or at a price equal to or greater than the offer price when the inside spread is less than  $\frac{1}{16}$ th.

<sup>9</sup> Securities Exchange Act Release No. 38294 (February 14, 1997), 62 FR 8289 (February 24, 1997) [File No. SR-NASD-97-07]. On October 3, 1997, the waiver of PMMs was extended until April 1, 1998. Securities Exchange Act Release No. 39198 (Oct. 3, 1997), 62 FR 53365 (Oct. 14, 1997) [SR-NASD-97-3].

<sup>10</sup> 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.

<sup>11</sup> Short Sale Rule Approval Order, *supra* note 5, at 34891.

<sup>12</sup> *Id.* at 34892.

<sup>13</sup> When the NASD's Rule was first considered by the Commission, the SEC received 397 comment

of short sales in a declining market above bid prices, Nasdaq believes the Rule does not diminish the important pricing efficiency and liquidity benefits that legitimate short selling activity provides.

#### *B. Self-Regulatory Organization's Statement on Burden on Competition*

The NASD believes that the proposed rule change will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Comments were neither solicited nor received.

### **III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action**

The NASD requests that its proposal to extend the effectiveness of the Rule and the amendment to the definition of a "legal" short sale until April 15, 1998, be approved on an accelerated basis prior to January 15, 1998.

### **IV. Commission's Findings and Order Granting Accelerated Approval of the Proposed Rule Change**

The Commission finds that the NASD's proposed rule change seeking to extend the pilot of the Rule and the amendment to the definition of "legal" short sale through April 15, 1998, is consistent with the Act and the rules and regulations promulgated thereunder. Specifically, the Commission finds that the proposed rule change is consistent with Section 15A(b)(6) of the Act which requires that the NASD rules be designed, among other things, to facilitate securities transactions and to protect investors and the public interest. The Commission believes that the proposed rule change is consistent with the Act because extension of the pilot and the amendment to the definition of a "legal" short sale for a short period of time will allow the Commission and the NASD to consider the potential problems associated with short selling, the changing expectations of Nasdaq market participants and the potential for competitive disparity between the exchange markets and the over-the-counter market. This extension also will afford the NASD time to submit to the Commission revised PMM standards and will allow the Commission to review on a contemporaneous basis these two integrally related rules (*i.e.*, the short sale and PMM rules). Once the

NASD develops reasonable PMM standards, the Commission will be in a better position to evaluate the need for a short sale rule as well as the appropriateness of an exemption for PMMs.

The Commission also finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof. The Commission believes that it is appropriate to approve on an accelerated basis the extension of the pilot program of the Rule and the amendment to the definition of "legal" short sale through April 15, 1998, because it will ensure the continuous operation of the Rule and the amendment to the definition of "legal" short sale, while the NASD addresses the Commission's questions and concerns, provides Commission staff with additional information about the practical effects and the operation of the revised PMM standards, and explores other options to PMM standards, such as a customer facilitation exemption for market makers.

### **V. Solicitation of Comments**

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. People making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 the filing will also be available for inspection and copying at the NASD's principal offices. All submissions should refer to File No. SR-NASD-97-94 and should be submitted by February 11, 1998.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change, SR-NASD-97-94 be, and hereby is approved through April 15, 1998.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>20</sup>

<sup>20</sup> 17 CFR 200.30-3(a)(12)(1997).

**Margaret H. McFarland,**

*Deputy Secretary.*

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## **SMALL BUSINESS ADMINISTRATION**

### **Region VIII Advisory Council Meeting; Public Meeting**

The U.S. Small Business Administration Regional VIII Advisory Council located in the geographical area of Salt Lake City, Utah, will hold a public meeting at 9:00 a.m. on Wednesday, February 18, 1998, at the Salt Lake Area Chamber of Commerce, Media Room, at 175 East 400 South, Suite 600, Salt Lake City, to discuss such matters as may be presented by members, staff of the U.S. Small Business Administration, or others present.

For further information, write or call Stan Nakano, District Director, U.S. Small Business, 125 South State Street, Salt Lake City, Utah 84138, (801) 524-5804.

**Eugene Carlson,**

*Associate Administrator, Office of Communication & Public Liaison.*

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## **DEPARTMENT OF TRANSPORTATION**

### **Office of the Secretary**

### **Reports, Forms and Recordkeeping Requirements Agency Information Collection Activity Under OMB Review**

**AGENCY:** Office of the Secretary, DOT.

**ACTION:** Notice and request for comments.

**SUMMARY:** In compliance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 et seq.), this notice announces that the Information Collection (ICR) abstracted below has been forwarded to the Office of Management and Budget (OMB) for review and comment. The ICR describes the nature of the information collection and its expected burden. The **Federal Register** Notice with a 60-day comment period soliciting comments on the following collection of information was published on October 30, 1997 [62 FR 58858].

**DATES:** Comments must be submitted on or before February 23, 1998.

**FOR FURTHER INFORMATION CONTACT:** Judith Street, ABC-100; Federal Aviation Administration; 800 Independence Avenue, S.W.;