

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

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which DTC consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons 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, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of DTC.

All submissions should refer to the file number SR-DTC-96-17 and should be submitted by November 29, 1996.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>7</sup>

Jonathan G. Katz,

Secretary.

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[Release No. 34-37917; File No. SR-NASD-96-41]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to an Extension of the NASD's Short Sale Rule

November 1, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on October 29, 1996, 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 and order 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 the pilot program for its short sale rule until October 1, 1997. The text of the proposed rule change is as follows. (Additions are italicized; deletions are bracketed.)

\* \* \* \* \*

#### NASD Rule 3350

\* \* \* \* \*

(1) This section shall be in effect until *October 1, 1997* [November 4, 1996].

#### 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. 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. Background and Description of the NASD's Short Sale Rule

On June 29, 1994, the SEC approved the NASD's short sale rule applicable to short sales<sup>2</sup> in Nasdaq National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.<sup>3</sup> The NASD's short sale 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>4</sup> The Rule is in effect during normal domestic market hours (9:30 a.m. to 4:00 p.m., Eastern Time).

In order 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, the Rule provides an exemption to "qualified" Nasdaq market makers. Even if a market maker is able to avail itself to the qualified market maker exemption, it can only utilize the exemption from the short sale rule for transactions that are made in connection with bona fide market making activity. If a market maker does not satisfy the requirements for a qualified market maker, it can remain a market maker in the Nasdaq system, although it cannot take advantage of the exemption from the Rule.

<sup>2</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 SEC Rule 3b-3, which rule is incorporated into Nasdaq's short sale rule by NASD Rule 3350(k)(1).

<sup>3</sup> See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994) ("Short Sale Rule Approval Order"). The termination date for the pilot program has subsequently been extended through November 4, 1996. See Securities Exchange Act Release Nos. 36171 (August 30, 1995), 60 FR 46651; 36532 (November 30, 1995), 60 FR 62519; and 37492 (July 29, 1996), 61 FR 40693.

<sup>4</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. Accordingly, absent an exemption from the rule, a member can not effect a short sale at or below the inside bid for a security in its proprietary account or a customer's account if there is a red arrow next to the security's symbol on the screen. In order to 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>7</sup> 17 CFR 200.30-3(a)(12) (1996).

<sup>1</sup> 15 U.S.C. § 78s(b)(1).

To be a "qualified" market maker, a market maker must satisfy the Nasdaq Primary Market Maker ("PMM") Standards. Under the PMM Standards, a market maker must satisfy at least two of the following four criteria 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  $1\frac{1}{2}$  times its "proportionate" volume in the stock.<sup>5</sup> If a market maker is a PMM for a particular stock, there is a "P" indicator next to its quote in that stock.<sup>6</sup>

The ability of a member firm to achieve and maintain PMM status in 80 percent of the NNM issues in which it is registered can also have the following corollary effects:

a. Existing NNM Securities: if a member firm is a PMM in 80 percent or more of the securities in which it has registered, the firm may immediately become a PMM (*i.e.*, a qualified market maker) in a NNM security by registering and entering quotations in that issue. If the member firm is not a PMM in at least 80 percent of its stocks, it may become a PMM in that stock if it registers in the stock as a regular Nasdaq market maker and satisfies the PMM qualification standards for the next review period.

b. Initial Public Offerings ("IPOs"): if a member firm has obtained PMM status in 80 percent or more of the stocks in which it has registered, the firm may immediately become a PMM in an IPO by registering and entering quotations in the issue. However, if the firm: (1) withdraws from the IPO on an unexcused basis any time during the calendar month in which the IPO

commenced trading on Nasdaq, or (2) fails to meet the PMM standards for the month in which the IPO commenced trading on Nasdaq, then the firm is precluded from becoming a PMM in any other IPO for ten business days following the unexcused withdrawal or failure to meet the PMM standards ("10-day rule").<sup>7</sup>

c. Merger and Acquisition Situations: after a merger or acquisition is announced, a market maker that is a PMM in one stock may immediately become a PMM in the order stock by registering and entering quotations in that issue.

In an effort not to constrain the legitimate hedging needs of options market makers and warrant market makers, the NASD's short sale rule also contains a limited exception for certain standardized options market makers and warrant market makers. The NASD's short sale rule also incorporates seven exemptions contained in SEC Rule 10a-1 that are relevant to trading of Nasdaq.<sup>8</sup>

## 2. Proposal To Extend the Short Sale Rule<sup>9</sup>

When the Commission approved the NASD's short sale 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 Nasdaq National Market securities is consistent with the Act."<sup>10</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>11</sup>

Nevertheless, 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>12</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. 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.

Accordingly, in July 1996, the NASD's Economic Research Department prepared a study on the economic impact of the NASD's short sale rule that addressed these issues.<sup>13</sup> While the NASD believes the study demonstrates that the short sale rule has not had any adverse market impacts, the NASD believes further study of the impact of the rule, particularly the market maker exemption, is needed in order for the NASD to adequately respond to the SEC's concerns and questions noted in the Short Sale Rule Approval Order.<sup>14</sup>

<sup>11</sup> *Id.* 59 FR at 34892.

<sup>12</sup> When the NASD's short sale rule was first considered by the Commission, the SEC received 297 comment letters on the proposal, with 275 comments opposed to the Rule and 122 comments in favor of the Rule. Those comment letters opposed to the Rule argued that: (1) the NASD had failed to provide sufficient evidence of the need for a short sale rule or demonstrate the appropriateness of a short sale 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 short sale rule is inconsistent with the requirements of the Act.

<sup>13</sup> The Economic Impact of the Nasdaq Short Sale Rule, NASD Economic Research Department (July 1996) ("Short Sale Study").

<sup>14</sup> In July 1996, The NASD submitted a proposal to adopt the short sale rule on a permanent basis. See Securities Exchange Act Release No. 37942 (July 29, 1996), 61 FR 40693 (SR-NASD-96-30). Because the NASD believes additional quantitative analysis is necessary to evaluate the effects of the Rule, the NASD has withdrawn this rule filing.

Continued

<sup>5</sup> Specifically, the proportionate volume test requires a market maker to account for volume of at least one-and-a-half times its proportionate share of overall volume in the security for the review period. For example, if a security has 10 market makers, each market maker's proportionate share volume is 10 percent. Therefore, the proportionate share volume is one-and-a-half times 10, or 15 percent of overall volume.

<sup>6</sup> In addition, market makers are able to review their status as PMMs through their Nasdaq Workstation. The review period for satisfaction of the PMM performance standards is one calendar month. If a PMM has not satisfied the threshold standards after a particular review period, the PMM designation will be removed on the next business day following notice of failure to satisfy the standards. Market makers may requalify for designation as a PMM by satisfying the threshold standards in the next review period.

<sup>7</sup> The PMM also has provisions applicable to secondary offerings. Specifically, unless a market maker is registered in a security prior to the time a secondary offering in that stock has been publicly announced or a registration statement has been filed, it cannot become a PMM in the stock unless: (1) the secondary offering has become effective and the market maker has satisfied the PMM standards between the time the market maker registered in the security and the time the offering became effective or (2) the market maker has satisfied the PMM standards for 40 calendar days.

<sup>8</sup> See NASD Rule 3350(c)(2)-(8).

<sup>9</sup> The Commission notes that this subsection, as well as the other portions of Section II of this proposed rule change, contains the NASD's statements on the basis and purpose of the short sale rule and its proposal to extend the pilot program, as well as burdens on competition and comments received.

<sup>10</sup> See Short Sale Rule Approval Order, *supra* note 3, 59 FR at 34891.

Accordingly, the NASD is proposing to extend its short sale rule until October 1, 1997, to afford the NASD the opportunity to conduct further analysis of the impact of the Rule.<sup>15</sup>

The NASD believes the proposed rule change is consistent with Section 15A(b)(6) of the Act. Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market. Specifically, the NASD believes that extending the pilot period for the short sale rule will enhance the quality of studies analyzing the effectiveness of the Rule and help to ensure that future regulatory action taken with respect to the Rule is based on a greater knowledge and understanding of the Rule.

#### *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. The NASD believes the primary market maker qualification standards are designed in a manner to permit market makers of all sizes to qualify as primary market makers. Moreover, it is important to note that market makers that do not meet the standards are still permitted to remain registered market makers in the Nasdaq system. In addition, without a

short sale rule for the Nasdaq market, Nasdaq would be adversely impacted in its ability to compete for listings with exchange markets.

#### *C. Self-Regulatory Organization's Statement on Comment 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 the Commission find good cause pursuant to Section 19(b)(2) of the Act<sup>16</sup> for approving the proposed rule change prior to the 30th day after publication in the Federal Register.

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

The Commission finds that the proposal to extend the short sale rule through October 1, 1997 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)<sup>17</sup> 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 approved the NASD short sale rule in 1994, on a pilot basis. The purpose of the pilot was to demonstrate that the rule accomplished its intended purpose and did not impose unnecessary costs on market participants. In July 1996, the NASD submitted an economic report on the pilot. While the Short Sale Study provides some data on the pilot, the Commission believes that the NASD needs to produce additional and more precise data to justify permanent adoption of the rule.<sup>18</sup> Hence the Commission is extending the short sale rule to provide the NASD with ample time to collect significantly more data and to determine if the Rule in its current form is appropriate. The data will aid the NASD and the Commission in determining the benefits and costs of the short sale rule pursuant to Section 15A(b)(6). The Commission finds good cause to approve the extension of the short sale rule pilot prior to the 30th day

after the date of publication of the notice of filing because accelerated approval will avoid disrupting the market while the NASD and the Commission consider the supplemental data that will be collected during the extension.

#### *V. Solicitation of Comments*

Persons 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 such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR-NASD-96-41, and should be submitted by November 29, 1996.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act, that the proposed rule change (File No. SR-NASD-96-41) be, and hereby is, approved on an accelerated basis through October 1, 1997.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

Margaret H. McFarland,  
Deputy Secretary.

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Letter from Robert E. Aber, Vice President and General Counsel, to Katherine England, Assistant Director, National Market Systems and Over-the-Counter, Commission (October 29, 1996). The Commission received one comment letter in regard to the NASD's proposal to adopt the short sale rule on a permanent basis. Letter from Daniel Parker Odell, Assistant Secretary, New York Stock Exchange, Inc., to Jonathan G. Katz, Secretary, Commission (September 6, 1996). The Commission will consider that letter in connection with any subsequent NASD proposal for permanent adoption of the short sale rule.

<sup>15</sup> Specifically, the Commission has requested that the NASD (1) require exempt market makers to begin reporting short sales, and (2) provide the Commission with a report examining the data collected with regard to this requirement including the number of short sales by exempt market makers and their potential effect on the purposes of the Rule. In this connection, at its meeting in November 1996, the Board of Directors of The Nasdaq Stock Market, Inc. will be considering whether to amend NASD Rule 6301(d)(6) to require market makers exempt from the Rule to mark their Automated Confirmation Transaction Service ("ACT") reports to denote when they have relied on the market maker exemption.

<sup>16</sup> 15 U.S.C. § 78s(b)(2).

<sup>17</sup> 15 U.S.C. § 78o-3(b)(6).

<sup>18</sup> Among other matters, the NASD needs to collect short sale information from exempt market makers and provide a report to the Commission, as well as measure more precisely the rule's effect on short sale activity.

[Release No. 34-37913; File No. SR-PSE-96-33]

#### **Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Stock Exchange, Inc. Relating to the Automated System Access Privilege Annual Membership Fee**

November 1, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on September 6, 1996, the Pacific Stock Exchange, Incorporated ("PSE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or "Commission")

<sup>19</sup> 17 CFR 200.30-3(a)(12) (1996).