

comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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-2003-166 and should be submitted by January 20, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁰

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48967; File No. SR-NASD-03-191]

Self-Regulatory Organizations; Notice of Filing of a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to an Extension of the Short Sale Rule and Continued Suspension of the Primary Market Maker Standards Set Forth in NASD Rule 4612

December 22, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 19, 2003, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change.

¹⁰ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

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

The Nasdaq is proposing to extend the pilot program of the National Association of Securities Dealers' short sale rule retroactively to December 15 and prospectively until June 15, 2004. The Nasdaq is also seeking to continue the suspension of the effectiveness of the Primary Market Maker ("PMM") standards currently set forth in NASD Rule 4162, also retroactive to December 15, 2003 and prospective through June 15, 2004. The text of the proposed rule change is as follows. Additions are *italicized*; deletions are bracketed.

* * * * *

NASD Rule 3350

(a)-(k) No Change.

(l) This section shall be in effect until June 15, 2004 [December 15, 2003].

* * * * *

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 Nasdaq 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 III below. The 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. Purpose

Background and Description of the NASD's Short Sale Rule. Section 10(a) of the Act³ gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange, as needed to protect investors. Although the Commission has regulated short sales since 1938, that regulation has been limited to short sales of exchange-listed securities. In 1992, the Nasdaq, believing that short-sale regulation is important to the orderly operation of securities markets, proposed a short sale rule for trading of its National Market securities that incorporates the protections provided by Rule 10a-1 under the Act.⁴ On June 29, 1994, the Commission approved the NASD's short

sale rule (the "Rule") applicable to short sales⁵ in Nasdaq National Market ("NNM") securities on an eighteen-month pilot basis through March 5, 1996.⁶ The NASD and the Commission have extended NASD Rule 3350 numerous times, most recently, until December 15, 2003.

The Rule employs a "bid" test rather than a tick test because Nasdaq trades are not necessarily reported to the tape in chronological order. The Rule prohibits short sales at or below the inside bid when the current inside bid is below the previous inside bid. The Nasdaq calculates the inside bid from all market makers in the security and disseminates symbols to denote whether the current inside bid is an "up-bid" or a "down-bid." To effect a "legal" short sale on a down-bid, the short sale must be executed at a price at least \$.01 above the current inside bid. The Rule is in effect from 9:30 a.m. until 4:00 p.m. each trading day.

In December of 2002, the Nasdaq modified the method it uses to calculate the last bid by having it refer to the "Nasdaq Inside" which is comprised of quotations from all participants in Nasdaq execution systems (e.g., SuperMontage), rather than referring to the National Best Bid and Offer ("NBBO"). The Nasdaq currently calculates and applies the Nasdaq-based bid tick indicator to all SuperMontage trades. With respect to trades executed outside Nasdaq execution systems and reported to the Nasdaq, Nasdaq participants have been permitted to transition from the NBBO-based bid tick to the Nasdaq-based bid tick, provided that each firm select and apply a single bid tick indicator for all such trades executed by that firm. That transition has not been completed and, as explained below, in light of the Commission's proposal of Regulation SHO, the Nasdaq has alerted members that it would not be prudent to transition from the NBBO bid tick to the Nasdaq bid tick at this time.

To reduce the compliance burdens on its members, the Rule also incorporates seven exemptions contained in Rule 10a-1 under the Act,⁷ and other exemptions that are relevant to trading

⁵ A short sale is a sale of a security that the seller does not own or any sale that 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 is incorporated into Nasdaq's short sale rule by NASD Rule 3350(k)(1).

⁶ See Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994) ("Short Sale Rule Approval Order").

⁷ 17 CFR 240.10a-1.

³ 15 U.S.C. 78a(10)(A).

⁴ 17 CFR 240.10a-1.

on the Nasdaq.⁸ 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.⁹

⁸ 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.

⁹ 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.¹⁰ 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.¹¹ 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.

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

¹¹ 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."¹²

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."¹³ 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."¹⁴ 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

¹² See Letter, dated September 27, 1999 from John F. Malitzis, Assistant General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division of Market Regulation, Commission.

¹³ See Short Sale Rule Approval Order, *supra* note 2.

¹⁴ *Id.*

securities and would supersede NASD Rule 3350. The Nasdaq has alerted market participants that the adoption of Regulation SHO would impact the regulation of short sales on the Nasdaq and on other markets in a number of ways. The adoption of Regulation SHO would supersede elements of this proposal, including requiring short sales on the Nasdaq to utilize an NBBO-based bid test and eliminating the application of primary market maker standards. The Nasdaq has encouraged firms to analyze the proposal and its impact on their execution and order management systems in anticipation of its adoption.

2. Statutory Basis

The Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A of the Act,¹⁵ in general and with Section 15A(b)(6) of the Act,¹⁶ 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. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the proposed rule change: (1) Does not significantly affect the protection of investors or the public interest; (2) does not impose any significant burden on competition; and (3) does not become operative for 30 days from the date of filing, or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁷ and Rule 19b-4(f)(6)¹⁸ thereunder.

A proposed rule change filed under Rule 19b-4(f)(6)¹⁹ normally does not

become operative prior to 30 days after the date of filing. However, pursuant to Rule 19b-4(f)(6)(iii),²⁰ the Commission may designate a shorter time if such action is consistent with the protection of investors and public interest. The Nasdaq seeks to have the proposed rule change become operative on or before December 16, 2003, in order to allow the Pilot to continue in effect on an uninterrupted basis. In addition, under Rule 19b-4(f)(6)(iii),²¹ the Nasdaq is required to provide the Commission with written notice of its intent to file the proposed rule change at least five business days prior to the filing date or such shorter time as designated by the Commission. The Commission has waived the five-day pre-notice requirement for this proposed rule change. In addition, for the reasons discussed below, the Commission has also waived the thirty-day operative date requirement for this proposed rule change.

The Commission notes that unless extended, the Pilot will expire, and this could disrupt the proper operation of the Nasdaq. At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. 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. Comments may also be submitted electronically at the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. SR-NASD-2003-191. This file number should be included on the subject line if e-mail is used. To help the Commission process and review comments more efficiently, comments should be sent in hardcopy or by e-mail but not by both methods. 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-2003-191 and should be submitted by January 20, 2004.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²²

Jill M. Peterson,

Assistant Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-48972; File No. SR-NASD-2003-185]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers, Inc. to Modify SuperMontage Pricing

December 22, 2003.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on December 11, 2003, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Nasdaq proposes to modify the pricing for Nasdaq's SuperMontage system. Pursuant to Section 19(b)(3)(A) of the Act,³ and Rule 19b-4(f)(6) thereunder,⁴ Nasdaq has designated the proposed rule change as non-controversial and requests that the Commission waive the 30-day pre-operative requirement contained in SEC

¹⁵ 15 U.S.C. 78o-3.

¹⁶ 15 U.S.C. 78o-3(6).

¹⁷ 15 U.S.C. 78s(b)(3)(A).

¹⁸ 17 CFR 240.19b-4(f)(6).

¹⁹ *Id.*

²⁰ 17 CFR 240.19b-4(f)(6)(iii).

²¹ 17 CFR 240.19b-4(f)(6).

²² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).