

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-50862; File No. SR-NASD-2004-150]

### Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment 1 Thereto by the National Association of Securities Dealers, Inc. Relating to an Interpretation of Rule 3350

December 15, 2004.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 4, 2004, 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. On December 6, 2004, Nasdaq filed Amendment No. 1 to the proposed rule change.<sup>3</sup> 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 is filing this proposed rule change to implement an interpretation of NASD Rule 3350, the "Short Sale Rule," as it applies to the execution functionality of the Nasdaq Market Center. Specifically, Nasdaq is interpreting Rule 3350(a) to establish that the bid arrow for each security subject to the Rule will be programmed to be an "up" arrow at the opening of the market, rather than calculated based upon changes from the previous day's closing bid.

Pursuant to Section 19(b)(3)(A)(i) of the Act<sup>4</sup> and Rule 19b-4(f)(1) thereunder,<sup>5</sup> Nasdaq has designated this proposal as constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule, and

therefore the proposed rule change is effective immediately upon filing.

The proposed rule language for this proposal is set forth below. Additions are italicized.<sup>6</sup>

\* \* \* \* \*

#### IM-3350. Short Sale Rule

(a)-(c) No Change.

*(d) Nasdaq calculates changes to the inside bid displayed in the Nasdaq Market Center and disseminates a "bid arrow" via Nasdaq data feeds for market participants to use to comply with Rule 3350 when utilizing the execution functionality of the Nasdaq Market Center. The initial bid arrow each day shall be calculated at market open as follows.*

*(1) For stocks subject to Rule 4709(c), the initial bid arrow after completing the process described in Rule 4709(c)(1) through (3) shall be up and the next and subsequent bid arrows shall be calculated by comparing the bid arrow with each quotation update processed by the Nasdaq system after the system begins processing pursuant to Rule 4709(c)(4).*

*(2) For stocks described in Rule 4704(d), the initial bid arrow at the conclusion of the Nasdaq Opening Cross shall be up and the next and subsequent bid arrows shall be calculated by comparing the bid arrow with each quotation update processed by the Nasdaq system after the Nasdaq Opening Cross concludes.*

\* \* \* \* \*

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, 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 IV 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. Purpose

Rule 3350(a)(2) states that with respect to trades executed on or reported to Nasdaq, "no member shall effect a short sale for the account of a

customer or for its own account in a Nasdaq National Market security at or below the current best (inside) bid displayed in the Nasdaq Market Center when the current best (inside) bid is below the preceding best (inside) bid in the security." Between the hours of 9:30 a.m. and 4 p.m., when Rule 3350 operates, Nasdaq continuously calculates changes to the best bid and disseminates that information to market participants via a "bid arrow" that is included in Nasdaq's quotation data feeds.

Rule 3350 is silent about how the bid arrow is to be calculated at the beginning of the trading day when Nasdaq is calculating its first inside bid and the first inside bid change. Upon approval of the Rule, the NASD issued a Notice to Members explaining the Rule's operation, which states that

- The calculation of "up bids" and "down bids" at the opening incorporates bids from the previous close. Thus, if the opening inside bid is the same as the previous day's closing inside bid, and the closing bid was a down bid, then the opening bid would be a down bid. Similarly, if the opening inside bid is below the previous day's closing inside bid, the opening inside bid is a down bid."

NASD NTM 94-68 (Aug. 1994) (Q&A #5). Thus, while there is no rule language or interpretation in the NASD rule manual, the publicly stated practice has been to calculate the opening bid tick by referring back to the prior day's closing bid.

Nasdaq believes that referring back to the previous day's closing bid no longer offers the investor protections that it did in 1994. In the interim, Nasdaq believes that the increase in quoting and trading after hours has reduced the relevance of the previous day's closing bid to the direction of the bid arrow at 9:30. In addition, Nasdaq believes the increased levels of transparency and surveillance in Nasdaq have reduced the risk of undetected manipulation and permit the NASD to monitor the types of activities that Rule 3350 is designed to prevent.

Nasdaq has determined that the better approach is to designate the opening bid arrow as an up arrow for all securities that are subject to the Rule. Under this approach, Nasdaq would program its system to generate and disseminate an up arrow for all subject securities at the start of trading, and to compute the next bid arrow by comparing the first bid change to it. The first bid arrow would always be up, but would immediately turn down if the first bid change to be processed after the market opens is at a price below the opening bid.

Disseminating an up arrow at the conclusion of the Nasdaq Opening Cross or at 9:30 for stocks in which there is

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

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

<sup>3</sup> See letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Kathy A. England, Assistant Director, Division of Market Regulation, Commission, dated December 6, 2004. Amendment No. 1 provides additional explanatory text that relates to the purpose of the proposed rule change.

<sup>4</sup> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>5</sup> 17 CFR 240.19b-4(f)(1).

<sup>6</sup> The proposed rule change is marked to show changes from the rule text appearing in the NASD Manual available at <http://www.nasdaq.com>.

no cross, is consistent with the Exchange Act and the policy underlying short sale regulation. Nasdaq believes that short selling provides the market with important benefits, such as market liquidity and pricing efficiency, and that short selling should not be restricted unnecessarily. As a result, the primary objective of short sale regulation is to prevent manipulative short selling, such as "bear raids" from driving the price of securities through successively lower price levels. Nasdaq also believes that its two opening processes, the Nasdaq Opening Cross and the Modified Opening Process, will reduce the incentive and potential effectiveness of manipulative short selling at the open by aggregating substantial trading interest and executing it in an organized, transparent fashion. After those processes are complete, the short sale bid arrow is immediately recalculated according to the first bids Nasdaq receives, making it immediately available to detect and address problematic short selling that could occur on Nasdaq. Nasdaq also notes that Nasdaq's proposed regulation of short selling is far more effective than the practice in other markets that currently trade Nasdaq securities with no price test at all.

Nasdaq will implement this change with the launch of its recently proposed modified opening process described in SR-NASD-2004-71.<sup>7</sup> In that filing, Nasdaq proposed to establish an Opening Cross for certain Nasdaq-listed stocks and to improve the opening process for all others. Under the interpretation herein, the bid arrow would be designated as an up arrow during the Opening Cross, which will be the first activity in the market at 9:30. The bid arrow would be up at the conclusion of the Opening Cross, and would change based upon the first bid change processed immediately following the Opening Cross. For Nasdaq stocks for which there is no Opening Cross, the bid arrow will be designated as an up arrow immediately at 9:30 and then will change based upon the first bids processed after 9:30.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>8</sup> which requires, among other things, that NASD rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in

general, to protect investors and the public interest. Nasdaq believes the proposed rule change is consistent with the Act in that it updates Nasdaq's short sale rule to reflect the increase in after-hours and pre-opening trading and also promotes compliance with and regulation of short sale requirements.

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

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

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

Written comments were neither solicited nor received.

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

The forgoing rule change has become effective pursuant to Section 19(b)(3)(A)(i)<sup>9</sup> of the Act, and subparagraph (f)(1) of Rule 19b-4,<sup>10</sup> because the proposal constitutes a stated policy, practice, or interpretation with respect to meaning, administration, or enforcement of an existing NASD rule. At any time within 60 days of the filing of a proposed rule change pursuant to Section 19(b)(3)(A) of the Act, the Commission may summarily abrogate the proposed 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.<sup>11</sup>

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File

<sup>9</sup> 15 U.S.C. 78s(b)(3)(A)(i).

<sup>10</sup> 17 CFR 240.19b-4(f)(1).

<sup>11</sup> For purposes of calculating the 60-day period within which the Commission may summarily abrogate the proposed rule change under Section 19(b)(3)(C) of the Act, the Commission considers that period to commence on December 6, 2004, the date Nasdaq filed Amendment No. 1. See 15 U.S.C. 78s(b)(3)(C).

Number SR-NASD-2004-150 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2004-150. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 Section, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of such filing also will be available for inspection and copying at the principal office of the NASD. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NASD-2004-150 and should be submitted on or before January 11, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>12</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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## SMALL BUSINESS ADMINISTRATION

### Region IV North Florida District Advisory Council; Public Meeting

The U.S. Small Business Administration (SBA) North Florida District Advisory Council located in Jacksonville, Florida, will host a public meeting at 12 p.m. e.s.t. on Wednesday, January 19, 2005 at the SBA North Florida District Office located at 7825

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

<sup>7</sup> Release No. 34-50405 (Sept. 16, 2004), 69 FR 57118 (Sept. 23, 2004) (Notice of Filing).

<sup>8</sup> 15 U.S.C. 78o-3(b)(6).