



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

DIVISION OF  
MARKET REGULATION

June 26, 2006

Marc Menchel  
Executive Vice President and General Counsel  
NASD, Inc.  
1735 K Street, NW  
Washington, D.C. 20006-1506

**Re: Request for Exemption from Securities Exchange Act Rule 10a-1  
File No. TP 06-75**

Dear Mr. Menchel:

In your letter dated February 16, 2006, as supplemented by telephone conversations with the staff, you request exemptive relief regarding Rule 10a-1 under the Securities Exchange Act of 1934 (Exchange Act) to permit (1) Nasdaq National Market securities traded over-the-counter and reported to a NASD facility to be subject to proposed NASD Rule 5100 rather than Rule 10a-1; and (2) Nasdaq Capital Market securities traded over-the-counter and reported to a NASD facility to not be subject to either Rule 10a-1 or proposed NASD Rule 5100. This response is attached to the enclosed photocopy of your letter. By doing this, we avoid having to recite or summarize the facts set forth in your letter. Each defined term in this response has the same meaning as defined in your letter, unless otherwise noted.

**Background:**

Rule 10a-1 governs short sales. Paragraph (a) of Rule 10a-1 governs short sales of any security registered on, or admitted to unlisted trading privileges on, a national securities exchange if such transactions are made pursuant to an effective transaction reporting plan as defined in Rule 600 of Regulation NMS. Unless a specific exemption applies, short sales are prohibited at a price that is either (1) below the last reported price of a transaction reported pursuant to an effective transaction reporting plan (a "minus tick"); and (2) at the last reported price if that the price is lower than the last reported different price (a "zero-minus tick"). Absent an exemption, once Nasdaq begins operation as a national securities exchange, Nasdaq National Market securities and Nasdaq Capital Market securities will be exchange-registered securities reported to an effective transaction reporting plan and therefore subject to Rule 10a-1, wherever they are traded.

Because Nasdaq was not an exchange, Rule 10a-1 did not previously apply to Nasdaq securities. Instead, Nasdaq adopted its own price test rule. Similarly, short sales in Nasdaq securities effected on any national securities exchange that traded Nasdaq securities on an unlisted trading privileges basis or in the over-the-counter market were also not subject to Rule 10a-1.

In 1994, the Commission granted temporary approval to the NASD to apply its own short sale rule to Nasdaq National Market securities.<sup>1</sup> NASD Rule 3350 prohibits short sales in Nasdaq National Market securities at or below the current best (inside) bid when the current best (inside) bid is below the previous best (inside) bid in a security. NASD Rule 3350 is inapplicable to National Capital Market securities. Since that time, the NASD has proposed and the Commission has granted extensions of Rule 3350. Recently, the NASD proposed to renumber current NASD Rule 3350 as NASD Rule 5100.<sup>2</sup>

In the Commission's order approving the Nasdaq Stock Market LLC's application to become an exchange,<sup>3</sup> the Commission granted a temporary exemption from Rule 10a-1 to permit the Nasdaq Exchange to apply a bid test<sup>4</sup> to short sales in Nasdaq National Market securities occurring on the Nasdaq Exchange and to allow Nasdaq Capital Market securities<sup>5</sup> to be exempt from the application of the tick test.<sup>6</sup> By doing so, the Commission maintained the status quo for Nasdaq National Market securities trading on Nasdaq.

In granting the exemption, the Commission noted that it believed that it is important to maintain the status quo of short sale regulation during the Regulation SHO Pilot Program ("Pilot Program") in order to avoid unnecessarily burdening the markets.<sup>7</sup> Under the Pilot Program, the

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<sup>1</sup> Securities Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).

<sup>2</sup> Securities Exchange Act Release No. 52049 (July 15, 2005).

<sup>3</sup> The Commission approved the Nasdaq's Exchange registration as a national securities exchange on January 13, 2006. See Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3350 (January 23, 2006) ("Nasdaq Exchange Order"). In the Nasdaq Exchange Order, the Commission conditioned the Nasdaq Exchange's operation as a national exchange on the satisfaction of certain enumerated requirements.

<sup>4</sup> Nasdaq Exchange Rule 3350, which is based on the current bid test of NASD Rule 3350.

<sup>5</sup> These were formerly known as Nasdaq SmallCap securities.

<sup>6</sup> The exemptions from Rule 10a-1 expire upon termination of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors.

<sup>7</sup> The Pilot Program was created pursuant to Rule 202T of Regulation SHO, which established procedures to allow the Commission to temporarily suspend short sale price tests so that the Commission could study the effectiveness of short sale price tests. Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004). In addition, pursuant to the terms of Regulation SHO, the Commission approved an order establishing a one-

Commission by order temporarily suspended short sale price tests in a group of securities to evaluate the overall effectiveness and necessity of such restrictions. We expect that the Commission will consider any further action on the adoption of a price test after the completion of the Pilot Program. In order to promote efficient regulation and to avoid unnecessarily burdening markets with the imposition of costs associated with implementing a price test that may be temporary, the Commission stated that it was necessary and appropriate in the public interest and consistent with the protection of investors to maintain the status quo for the price test after Nasdaq becomes an exchange.

As a result, Nasdaq will be able to trade its securities under its bid test. However, over-the-counter sales of Nasdaq securities reported to a NASD facility would default to Rule 10a-1's tick test unless exempted.

You have requested an exemption to regulate over-the-counter short sales of Nasdaq National Market securities reported to a NASD facility under proposed NASD Rule 5100 and to permit over-the-counter short sales of Nasdaq Capital Market securities to remain uncovered by any price test. You state that the requested exemption would serve the public interest and protect investors by maintaining the status quo for short sales in Nasdaq securities during the Regulation SHO Pilot Program.

**Response:**

We find that it is appropriate in the public interest and consistent with the protection of investors, to grant an exemption from Rule 10a-1, pursuant to Rule 10a-1(f) on the basis of your representations, but without necessarily concurring in your analysis, (1) to permit Nasdaq National Market securities traded over-the-counter and reported to a NASD facility to be subject to proposed NASD Rule 5100 rather than SEC Rule 10a-1; and (2) to permit Nasdaq Capital Market securities traded over-the-counter and reported to a NASD facility to remain uncovered by any price test.

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year Pilot Program suspending the provisions of Rule 10a-1(a) under the Exchange Act and any short sale price test of any exchange or national securities association for short sales of certain securities for certain time periods. See Securities Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004) at <http://www.sec.gov/rules/other/34-50104.htm>; Securities Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004) at <http://www.sec.gov/rules/other/34-50747.htm>. The Pilot Program commenced on May 2, 2005 and is scheduled to end on August 6, 2007.

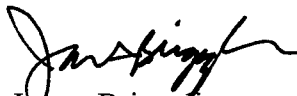
The Commission grants this exemption from Rule 10a-1 subject to the following conditions:

1. the continued application of NASD Rule 3350 (or, when renumbered, NASD Rule 5100) to Nasdaq National Market securities;
2. the NASD will issue a Notice to Members regarding what activity would not be deemed bona fide market making activity for purposes of claiming the exception to NASD Rule 5100's bid test; and
3. the NASD will implement a surveillance program to monitor whether firms claiming the bona fide market maker exception in NASD Rule 5100 are engaged in bona fide market making activity.

This exemption is effective until completion of the Pilot Program or at such other time if the Commission determines that such exemptions are no longer necessary or appropriate in the public interest or consistent with the protection of investors

The foregoing exemption from Rule 10a-1 is based solely on your letter dated February 16, 2006 and the representations and the facts you have presented to the staff, and is strictly limited to the application of this rule to transactions under the circumstances described above. Such transactions should be discontinued, pending presentation of the facts for our consideration, in the event that any material change occurs with respect to any of those facts or representations. The exemption granted herein is subject to modification or revocation if at any time the Commission determines that such action is necessary or appropriate in furtherance of the purposes of the Exchange Act. In addition, your attention is directed to the anti-fraud and anti-manipulation provisions of the Exchange Act, particularly Sections 9(a) and 10(b), and Rule 10b-5 thereunder. Responsibility for compliance with these and other applicable provisions of the federal or state securities laws must rest with participants to the transactions. The Division expresses no view with respect to other questions that the proposed transactions may raise, including, but not limited to, the applicability of other federal and state laws to the proposed transactions.

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



James Brigagliano  
Acting Associate Director

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February 16, 2006

**DIVISION OF MARKET REGULATION**



James A. Brigagliano  
Assistant Director  
Division of Market Regulation  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549

RE: Request for Exemption from Rule 10a-1 under the Securities Exchange Act  
of 1934

Dear Mr. Brigagliano:

NASD, Inc. ("NASD") respectfully requests that the Securities and Exchange Commission ("Commission" or "SEC") grant an exemption, pursuant to its authority under Section 36 of the Securities Exchange Act of 1934 ("Exchange Act"), from the application of Rule 10a-1 under the Exchange Act ("SEC Rule 10a-1") to: (1) permit Nasdaq National Market securities traded over-the-counter and reported to a NASD facility to be subject to proposed NASD Rule 5100 rather than SEC Rule 10a-1; and (2) permit Nasdaq Capital Market securities traded over-the-counter and reported to a NASD facility to not be subject to either SEC Rule 10a-1 or proposed NASD Rule 5100.<sup>1</sup>

**Background and Discussion**

As you know, the SEC approved The Nasdaq Stock Market, LLC ("Nasdaq") application for registration as a national securities exchange under Section 6 of the Exchange Act.<sup>2</sup> As you are also aware, NASD has filed a proposed rule change to amend its rules to reflect the anticipated operation of Nasdaq as a national securities exchange

<sup>1</sup> SEC Rule 10a-1 governs short sales of securities registered on, or admitted to unlisted trading privileges on, a national securities exchange, if trades in such securities are reported pursuant to an "effective transaction reporting plan" as defined in Rule 600 of Regulation NMS and information as to such trades is made available in accordance with such plan on a real-time basis to vendors of market transaction information ("registered securities"). Under SEC Rule 10a-1, unless there is an exemption, short sales are prohibited at a price that is either (1) below the price at which the last sale thereof, regular way, was reported pursuant to an effective transaction reporting plan; or (2) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was reported pursuant to an effective transaction reporting plan. Currently, NASD Rule 3350 governs short sales in Nasdaq National Market securities and generally prohibits members from effecting short sales in Nasdaq National Market securities at or below the inside bid when the current inside bid is below the previous inside bid. As part of NASD's proposed rule filing related to the separation of Nasdaq from NASD, NASD has proposed to renumber current NASD Rule 3350 as NASD Rule 5100 and, consistent with its application today, would apply to over-the-counter transactions reported to the Alternative Display Facility ("ADF") or the Trade Reporting Facility ("TRF").

<sup>2</sup> See Exchange Act Release No. 53128 (Jan. 13, 2006).

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operation of Nasdaq as a national securities exchange and its resultant separation from NASD.<sup>3</sup> Once Nasdaq begins operation as a national securities exchange, absent exemptive relief, SEC Rule 10a-1 governing short sales of registered securities would become applicable to short sales in Nasdaq National Market securities and Nasdaq Capital Market securities (collectively referred to as "Nasdaq-listed securities") wherever they are traded, including Nasdaq-listed securities traded over-the-counter.

The Commission has granted Nasdaq an exemption from the application of SEC Rule 10a-1 to: (1) permit Nasdaq National Market securities to become subject to Nasdaq Rule 3350 rather than SEC Rule 10a-1; and (2) permit Nasdaq Capital Market securities to remain subject to neither SEC Rule 10a-1 nor Nasdaq Rule 3350. NASD is hereby requesting that the Commission grant a similar exemption from the application of SEC Rule 10a-1 pursuant to its authority under Section 36 of the Exchange Act for short sales in Nasdaq-listed securities traded over-the-counter and reported to NASD facilities, consistent with any exemptive relief granted to Nasdaq.

NASD believes the requested exemption would serve the public interest and protect investors by maintaining consistent regulation of short sales in Nasdaq-listed securities, whether traded over-the-counter or on the Nasdaq exchange. NASD believes that denying the requested relief and subjecting Nasdaq-listed stocks traded over-the-counter to a different short sale price test than Nasdaq-listed securities traded on the Nasdaq exchange would cause investor and market participant confusion. In addition, the SEC is currently conducting a pilot program that excludes designated securities from the tick test of SEC Rule 10a-1 and any short sale price test of any exchange or national securities association for a designated period of time.<sup>4</sup> Therefore, NASD believes that it is necessary and appropriate to maintain the status quo for the bid test applying to short sales in Nasdaq National Market securities, and to continue to not apply to Nasdaq Capital Market securities.

Accordingly, NASD respectfully requests that the Commission grant the exemption described herein from SEC Rule 10a-1 for short sales in Nasdaq-listed securities traded over-the-counter and reported to an NASD facility, subject to the following two conditions: (1) NASD will issue a Notice to Members to provide further clarification to members regarding what activity would not be deemed "bona fide market making activity" for purposes of claiming the exception to NASD Rule 5100's bid test; and (2) NASD will implement a surveillance program, consistent with the guidance provided in the aforementioned Notice to Members, to monitor whether firms claiming the bona fide market maker exception in NASD Rule 5100 are engaged in bona fide market making activity.

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<sup>3</sup> See Exchange Act Release No. 52049 (July 15, 2005); 70 FR 42398 (July 22, 2005).

<sup>4</sup> See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (Aug. 6, 2004). See also, Exchange Act Release No. 50747 (Nov. 29, 2004), 69 FR 70480 (Dec. 6, 2005).

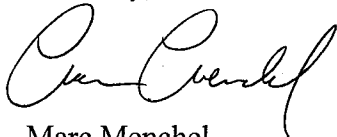
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If there are any questions concerning this request, please contact Stephanie Dumont, Vice President and Associate General Counsel, Office of General Counsel at (202) 728-8176.

Sincerely,

A handwritten signature in cursive script, appearing to read "Marc Menchel".

Marc Menchel  
Executive Vice President  
and General Counsel