

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-54601; File No. SR-NASDAQ-2006-037)

October 13, 2006

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Modify NASDAQ Rules 3350 and 4755

Pursuant to Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 27, 2006, The NASDAQ Stock Market LLC (“Nasdaq”), filed with the Securities and Exchange Commission (“Commission” or “SEC”) the proposed rule change as described in Items I, and II below, which Items have been prepared by Nasdaq. On October 12, 2006, Nasdaq filed Amendment No. 1 to the proposed rule change.<sup>3</sup> Nasdaq has requested that this proposal, as amended, be approved on an accelerated basis by October 16, 2006 to coincide with the launch of Nasdaq’s new Single Book execution system. The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons. In addition, the Commission is granting accelerated approval of the proposed rule change, as amended.

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

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

<sup>3</sup> In Amendment No. 1, which supplemented the original filing, Nasdaq made certain technical and clarifying changes following discussions with Commission staff.

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

Nasdaq proposes to modify Nasdaq Rule 3350(a) to establish the national best bid rather than the Nasdaq best bid, as the basis for determining compliance with Nasdaq Rule 3350(a).

Nasdaq also proposes to amend Nasdaq Rule 4755(a)(2) to clearly describe the test that Nasdaq's Single Book execution system will use to validate for compliance with applicable short sale rules for all securities that trade through the system.

The text of the proposed rule change, as amended, is below. Proposed new language is underlined; proposed deletions are in brackets.<sup>4</sup>

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**3350 Short Sale Rule**

(a) With respect to trades executed on Nasdaq, no member shall effect a short sale for the account of a customer or for its own account in a Nasdaq Global Market security at or below the current best (inside) bid displayed in the [Nasdaq Market Center] National Market System when the current best (inside) bid is below the preceding best (inside) bid in the security. For purposes of this rule, the term "customer" includes a non-member broker-dealer.

(b) - (1) No Change.

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**4755. Order Entry Parameters**

**(a) System Orders**

(1) No Change.

(2) Short Sale Compliance-System orders to sell short shall not be executed if the execution of such an order would violate any applicable short sale

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<sup>4</sup> Changes are marked to the rule text that appears in the electronic NASDAQ Manual found at [www.nasdaqtrader.com](http://www.nasdaqtrader.com).

regulation of the SEC or Nasdaq. For Nasdaq securities, the System shall validate for short sale compliance using a bid tick based upon changes to the national best bid and offer disseminated pursuant to an effective transaction reporting plan. For NYSE and Amex securities, the System shall validate for short sale compliance based upon changes to the consolidated last sale disseminated pursuant to an effective transaction reporting plan.

(3) - (4) No Change.

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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, as amended, and discussed any comments it received on the proposed rule change, as amended. The text of these statements may be examined at the places specified in Item III 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

Nasdaq proposes to modify Rule 3350(a) and Rule 4755(a)(2) to state that short sale compliance for Nasdaq securities will be based upon changes to the national best bid and offer ("NBBO") as is currently the case in the INET system, as opposed to changes in the Nasdaq best bid as is currently the case in the Nasdaq Market Center.

**Background.** Nasdaq states that Section 10(a) of the Act gives the Commission plenary authority to regulate short sales of securities registered on a national securities exchange, as needed to protect investors. Nasdaq notes that although the Commission

has regulated short sales since 1938, that regulation has been limited to short sales of exchange-listed securities. Nasdaq states that in 1992, Nasdaq, believing that short-sale regulation was important to the orderly operation of securities markets, proposed a short sale rule for trading of Nasdaq National Market securities that incorporated the protections provided by SEC Rule 10a-1. Nasdaq notes that on June 29, 1994, the SEC approved the NASD's short sale rule applicable to short sales in Nasdaq Global Market securities.<sup>5</sup> Nasdaq states that in its January 13, 2006, order approving Nasdaq's registration as a national securities exchange, the Commission granted Nasdaq an exemption from Rule 10a-1 to permit the application of Nasdaq Rule 3350 (the "Nasdaq Rule") rather than SEC Rule 10a-1 to the trading of Nasdaq-listed securities on Nasdaq.<sup>6</sup> Nasdaq notes, however, that SEC Rule 10a-1 continues to apply to the trading of securities listed on other national securities exchanges.

Nasdaq states that the Nasdaq Rule employs a "bid" test rather than a tick test because Nasdaq trades are not necessarily reported to the tape in chronological order. Nasdaq notes that, currently, its short sale rule prohibits short sales at or below the inside bid when the current inside bid is below the previous inside bid. Nasdaq notes that it 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." In addition, Nasdaq notes that 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. Nasdaq states that the

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<sup>5</sup> Formerly referred to as "Nasdaq National Market" securities. See Securities Exchange Act Release No. 54071 (June 29, 2006); 71 FR 38922 (July 10, 2006) (approving name change).

<sup>6</sup> Securities Exchange Act Release No. 53128 (Jan. 13, 2006).

Nasdaq Rule is in effect from 9:30 a.m. until 4:00 p.m. each trading day. Also, Nasdaq notes that from the time the Nasdaq Rule was implemented until December of 2002, Nasdaq utilized the NBBO to calculate the bid tick used to determine short sale compliance.

Nasdaq states that in December of 2002, Nasdaq modified the method it used to calculate the last bid by having it refer to the “Nasdaq Inside” which is comprised of quotations from all participants in the Nasdaq Market Center (known then as SuperMontage), rather than referring to the NBBO.<sup>7</sup> Nasdaq notes that it currently calculates and applies the Nasdaq-based bid tick indicator to all Nasdaq Market Center trades. With respect to trades executed outside Nasdaq execution systems and reported to Nasdaq, however, Nasdaq states that Nasdaq participants have been permitted to validate for short sale compliance by reference either to the NBBO-based bid tick or to the Nasdaq-based bid tick, provided that each firm selects and applies a single bid tick indicator for all such trades executed by that firm.

Nasdaq notes that it elected to apply the Nasdaq-based bid tick because at that time the NBBO was regularly different from the best bid that was reasonably accessible to many market participants. Nasdaq states that this would occur when a market that was relatively inaccessible, such as a manual, floor-based market with no electronic linkages, submitted a bid to the network processor that became part of the NBBO. When that bid created a down arrow for the NBBO-based bid tick, Nasdaq participants would be precluded from executing short sales, absent an exemption. Nasdaq notes that this was true even where Nasdaq participants could not access the other market and even though

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<sup>7</sup> See Securities Exchange Act Release No. 46999 (Dec. 13, 2002); 67 FR 78534 (Dec. 24, 2002).

that market did not itself impose a bid-based short sale restriction. In that case, Nasdaq states that the Nasdaq participant could not execute a short sale on Nasdaq due to the downward bid tick, nor could it execute the sale on the inaccessible market due to the absence of a linkage with that market. Nasdaq notes that at the same time, Nasdaq's execution system could be forced to halt processing while the inaccessible market set the NBBO. Nasdaq believed that this situation was inequitable and that the appropriate outcome was to establish a bid tick based upon quotes that were accessible through Nasdaq systems.

***Rationale for Proposal.*** Nasdaq states that its rationale for using the Nasdaq-based bid tick rather than the NBBO-based bid tick for short sale compliance is less powerful today, and there are countervailing interests today that did not exist in 2002. Nasdaq states that as Nasdaq and the rest of the industry approach the implementation of Regulation NMS, the NBBO has assumed, and will continue to assume, increased importance, and participants will modify their systems to utilize the NBBO for a variety of trading, routing, and compliance purposes. Nasdaq notes that the majority of Nasdaq members are using the NBBO-based bid tick rather than the Nasdaq-based bid tick, and it is expected that more firms will do so as they program their systems to comply with Regulation NMS. Thus, Nasdaq states that to maintain its use of the Nasdaq-based bid tick would, at this point in time, fly in the face of overwhelming regulatory and industry momentum.

Nasdaq believes that due to the relative activity on Nasdaq's systems, it will be far more disruptive for Nasdaq to apply the Nasdaq-based bid tick than to apply the NBBO-based bid tick. Nasdaq states that the INET system currently uses the NBBO-

based bid tick, and it accounts for approximately 32 percent of consolidated trading in Nasdaq securities, whereas the Nasdaq Market Center accounts for approximately 11 percent market share in Nasdaq securities. Therefore, Nasdaq believes it will be less disruptive to continue using the NBBO-based bid tick employed by current INET users.

In addition, Nasdaq notes that the NASD recently announced that all NASD members that execute short sales in the over-the-counter market must utilize the NBBO-based bid tick no later than November 3, 2006. Thus, Nasdaq states that since the vast majority of Nasdaq members are also NASD members that trade over-the-counter, Nasdaq members are already on notice that their systems must use the NBBO-based bid tick for short sale compliance by November 3. Nasdaq states that by moving to the NBBO-based bid tick, Nasdaq will be creating uniformity among joint NASD/Nasdaq members that trade Nasdaq securities on Nasdaq and in the over-the-counter markets. In addition, Nasdaq notes that this coincides almost exactly with the final roll-out of Nasdaq's new Single Book execution system. Nasdaq states that it would be more disruptive to require Nasdaq to continue to apply the Nasdaq-based bid tick during the roll-out of the Single Book execution system.

Nasdaq is also proposing to amend Rule 4755(a)(2) to clearly describe the test that Nasdaq's Single Book execution system will use to validate for compliance with applicable short sale rules for all securities that trade through the system. Nasdaq states that for Nasdaq-listed securities, the rule states that the system will use a bid tick based upon the NBBO. For NYSE- and Amex-listed securities, the system will use a tick based upon changes to the last sale reported pursuant to an effective transaction reporting plan for those securities.

## 2. Statutory Basis

Nasdaq believes that the proposed rule change, as amended, is consistent with the provisions of Section 6 of the Act,<sup>8</sup> in general, and with Section 6(b)(5) of the Act,<sup>9</sup> 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

Nasdaq does not believe that the proposed rule change, as amended, will 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

Written comments were neither solicited nor received.

## III. 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

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<sup>8</sup> 15 U.S.C. 78f.

<sup>9</sup> 15 U.S.C. 78f(b)(5).



- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2006-037 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2006-037. 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, 100 F Street, NE, Washington, DC 20549. 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-NASDAQ-2006-037 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

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

After careful consideration, the Commission finds that modification of the method used to calculate the bid tick indicator to determine the permissibility of a short sale and the clarification regarding which short sale price test Nasdaq's Single Book execution system will use to validate for compliance for short sales traded through the system are consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>10</sup> In particular, the Commission finds that the proposed rule change, as amended, is consistent with the requirements of Section 6(b)(5) of the Act,<sup>11</sup> which requires, among other things, that Nasdaq's rules be designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest.

Nasdaq has requested that the Commission find good cause for approving the proposed rule change, as amended, prior to the 30<sup>th</sup> day after publication of notice thereof in the Federal Register. Nasdaq has confirmed to the Commission that it would be more disruptive to market participants to continue to determine the permissibility of a short sale based on the Nasdaq-based bid tick rather than on the NBBO-based bid tick following implementation of Nasdaq's Single Book execution system. In addition, Nasdaq has stated that it does not believe that firms will face compliance issues, from a

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<sup>10</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>11</sup> 15 U.S.C. 78f(b)(5).

systems perspective or otherwise, if Nasdaq's Single Book execution system validates for short sale compliance based on the NBBO-based bid tick rather than on the Nasdaq-based bid tick. Thus, the Commission finds good cause exists, consistent with Sections 6(b)(5) and 19(b)(2) of the Act,<sup>12</sup> to approve the proposed rule change, as amended, on an accelerated basis, prior to the 30<sup>th</sup> day after the date of publication of the notice of filing thereof in the Federal Register.

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<sup>12</sup> 15 U.S.C. 78f(b)(5); 15 U.S.C. 78s(b)(2).

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act that the proposed rule change (SR-NASDAQ-2006-037) is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>13</sup>

Nancy M. Morris  
Secretary

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<sup>13</sup> 17 CFR 200.30-3(a)(12).