

NASD NOTICE TO MEMBERS 97-74

SEC Approves Amendments To Legal Definition Of Short Sale

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Executive Summary

On September 26, 1997, the Securities and Exchange Commission (SEC) approved an amendment to the National Association of Securities Dealers, Inc. (NASD[®]) short sale rule to provide that a "legal" short sale can be effected at a price equal to or greater than the offer price when the inside spread is less than 1/16th. The rule change has been approved on a temporary basis effective immediately through January 15, 1998, at which time the SEC will consider permanent approval of the rule change as well as permanent approval of the NASD's short sale rule.

Questions regarding this rule change should be directed to Andrew S. Margolin, Senior Attorney, The Nasdaq Stock Market, Inc., at (202) 728-8869.

Background And Summary

The NASD's short sale rule¹ prohibits member firms from effecting short sales² at or below the current inside bid, as disseminated by The Nasdaq Stock MarketSM (Nasdaq[®]) whenever that bid is lower than the previous inside bid.³ Previously, the rule provided that a short sale is a "legal" short sale in a "down" bid situation if it is effected at a price at least 1/16th above the inside bid ("Minimum Increment Rule"). The Minimum Increment Rule was implemented to ensure that short sales were not effected at prices so close to the inside bid during down markets that they were inconsistent with the underlying purposes of the short sale rule (*i.e.*, to prohibit market destabilizing and abusive short sales in declining markets).

Now that all Nasdaq stocks can potentially trade with a 1/16th spread or less due to, among other things, the new SEC Order Execution Rules, and in light of the movement toward

smaller minimum quotation variations generally, consideration was given to modifying the Minimum Increment Rule for stocks with an inside spread less than 1/16th.

Accordingly, the NASD has amended the Minimum Increment Rule to provide that a "legal" short sale must be effected at a price equal to or greater than the offer price when the inside spread is less than 1/16th. There would be no change to the current definition for stocks with a spread of 1/16th or greater. For example, if the inside market for ABCD is 10 1/4 – 10 5/16, a legal short sale in a down market would have to be effected at a price equal to or greater than 10 5/16 (*i.e.*, 1/16th above the current inside bid). However, if the inside market is 5 1/32 – 5 2/32, a legal short sale in a down market could be effected at a price of 5 2/32.

In addition, to help ensure that market participants do not adjust their quotations to circumvent the short sale rule, the NASD is proposing an amendment to the Minimum Increment Rule to provide that a market maker or customer could not bring about or cause the inside spread for a stock to narrow in a declining market (*e.g.*, lowering its offer to create an inside spread less than 1/16th) for the purpose of facilitating the execution of a short sale at a price less than 1/16th above the inside bid.

Text Of Amendments

(Note: New language is underlined.)

IM-3350 Short Sale Rule

(a) No Change

(b) (1) Rule 3350 requires that 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 cur-

rent best (inside) bid when the current best (inside) bid as displayed by The Nasdaq Stock Market is below the preceding best (inside) bid in the security. The Association has determined that in order to effect a “legal” short sale when the current best bid is lower than the preceding best bid the short sale must be executed at a price of at least 1/16th point above the current inside bid when the current inside spread is 1/16th point or greater. The last sale report for such a trade would, therefore, be above the inside bid by at least 1/16th of a point. If the current spread is less than 1/16th of a point, however, the short sale must be executed at a price equal to or greater than the current inside offer price.

(2) Moreover, the Association believes that requiring short sales to be a minimum increment of 1/16th point above the bid when the current spread is 1/16th or greater and equal to or greater than the offer when the current spread is less than 1/16th ensures that transactions are not effected at prices inconsistent with

the underlying purpose of the Rule. It would be inconsistent with Rule 3350 for a member or customer to cause the inside spread for an issue to narrow when the current best bid is lower than the preceding best bid (e.g., lowering its offer to create an inside spread less than 1/16th) for the purpose of facilitating the execution of a short sale at a price less than 1/16th above the inside bid.

(c) No Change

Endnotes

¹ The short sale rule was originally adopted in June of 1994 for Nasdaq National Market securities on a pilot basis with a termination date of March 5, 1996. *See Exchange Act Release No. 34277 (June 29, 1994), 59 FR 34885 (July 7, 1994).* The pilot has been extended several times, most recently through January 15, 1998. *See Exchange Act Release No. 39140 (September 26, 1997).* On August 11, 1997, the NASD filed a proposed rule change with the Commission to implement the short sale rule on a permanent basis. *See Exchange Act Release No. 38979 (August 26, 1997), 62 FR 46537 (September 3, 1997).*

² 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 Exchange Act Rule 3b-3, 17 CFR 240.3b-3, which rule is incorporated into Nasdaq’s short sale rule as NASD Rule 3350(k)(1).

³ 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.

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