

# NASD NOTICE TO MEMBERS 97-15

## SEC Approves Amendments To ACT Rules To Require Market Makers To Denote When They Have Effected An Exempt Short-Sale

### Suggested Routing

- ☐ Senior Management
- ☐ Advertising
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### Executive Summary

On February 5, 1997, the Securities and Exchange Commission (SEC) approved an amendment to the Automated Confirmation Transaction (ACT<sup>SM</sup>) Service rules (NASD<sup>®</sup> Rule 6130) to require all Market Makers to mark their ACT reports to denote when they have relied on the Market Maker exemption to the NASD short-sale rule.<sup>1</sup> The effective date for the Rule change is April 7, 1997.

### Background And Summary

On June 29, 1994, the SEC approved the NASD short-sale rule applicable to short sales<sup>2</sup> in Nasdaq National Market<sup>®</sup> securities on an 18-month pilot basis through March 5, 1996. The termination date for the pilot program has subsequently been extended through October 1, 1997. The NASD short-sale rule prohibits member firms from effecting short sales at or below the current inside bid as disseminated by Nasdaq<sup>®</sup> whenever that bid is lower than the previous inside bid.<sup>3</sup> The NASD short-sale rule is in effect during normal domestic market hours (9:30 a.m. to 4:00 p.m., Eastern Time).

To ensure that Market Maker activities that provide liquidity and continuity to the market are not adversely constrained when the NASD short-sale rule is invoked, the Rule provides an exemption to “qualified” Nasdaq Market Makers. Even if a Market Maker is able to avail itself of the qualified Market Maker exemption, it can only utilize the exemption from the short-sale rule for transactions that are made in connection with bona fide market-making activity. Beginning in February 1996, to be a “qualified” Market Maker, a Market Maker had to satisfy Nasdaq’s Primary Market Maker (PMM) standards.<sup>4</sup> If a Market Maker is a PMM for a particular stock, there is a “P” indicator next to its quote in that stock. **However,**

**because of another NASD rule proposal recently approved by the SEC, starting March 3, 1997, all Market Makers registered in and quoting a Nasdaq National Market security were deemed to be a PMM in that security. Accordingly, all Market Makers registered in and quoting a Nasdaq National Market security are now deemed to be “qualified” Market Makers and eligible to rely on the Market Maker exemption from the NASD short-sale rule.<sup>5</sup>** In this connection, all Market Makers will be PMMs for the remainder of the current pilot period for the NASD short-sale rule or until such time when new PMM standards are devised and adopted.

To enhance the NASD’s ability to surveil for compliance with the short-sale rule, when the SEC approved the NASD short-sale rule it also approved an NASD proposal to require NASD members to append a designator to their ACT reports to denote whether their sale transactions were long sales, short sales, or exempt short sales. Market Makers exempt from the short-sale rule were not required to append “sell short” or “sell short exempt” to their ACT reports, however. Specifically, the footnote to NASD Rule 6130(d)(6) provided that “[t]he ‘sell short’ and ‘sell short exempt’ indicators must be entered for all customer short sales, including cross transactions, and for short sales effected by members that are not qualified Market Makers pursuant to Rule 3350.” Accordingly, in order to enhance the NASD’s ability to surveil for potential abuses of the Market Maker exemption and examine and monitor the market impacts of the Market Maker exemption, the NASD proposed and the SEC approved the deletion of the footnote to NASD Rule 6130(d)(6), thereby requiring all exempt Market Makers to mark their ACT reports to denote when they have relied on the Market Maker exemption. **As a result, effec-**

**tive April 7, 1997, any and all Market Makers relying on the Market Maker exemption to the NASD short-sale rule to effect a short sale at a price at or below the inside bid when such bid is lower than the previous inside bid, must mark their ACT report for such transaction “sell short exempt.”** As noted above, because all Market Makers registered in and quoting a Nasdaq National Market security are now deemed to be a PMM in that security, this requirement applies to any Market Maker relying on the Market Maker exemption.

To determine whether a particular sale is a short sale (or an exempt short sale in the case of a “qualified” Market Maker), members must adhere to the definition of a “short sale” contained in SEC Rule 3b-3, which is incorporated into the NASD rules as Rule 3350(k)(1). In this connection, consistent with SEC statements regarding the intraday netting obligations of firms under SEC Rule 3b-3, the NASD notes that it will be permissible for firms to conduct a “firm-wide netting” of long and short positions once a day. Accordingly, the NASD believes it would be permissible for a Nasdaq trading desk to receive a stock position report at the opening and net those trades effected by the Nasdaq trading desk against this position throughout the day to determine whether a particular sale was long or short. Of course, if a firm has developed the capability to continuously net its positions throughout the day, that firm would have to rely on such updated position reports to determine whether a particular sale was long or short.<sup>6</sup>

Questions regarding this Rule change should be directed to Thomas R. Gira, Associate General Counsel, Nasdaq, at (202) 728-8957. Questions regarding the marking of ACT Reports should be directed to Pete Forte, Nasdaq Market Operations, at (203) 385-6244.

## Text Of Amendments

*(Note: Deletions are bracketed.)*

### 6130. Trade Report Input

(a) through (c) No change.

(d) Trade Information To Be Input

Each ACT report shall contain the following information:

(1) - (5) No change.

(6) A symbol indicating whether the transaction is a buy, sell, sell short, sell short exempt[\*] or cross;

(7) - (12) No change.

(e) No change.

[\* The “sell short” and “sell exempt” indicators must be entered for all customer short sales, including cross transactions, and for short sales effected by members that are not qualified market makers pursuant to Rule 3350.]

## Endnotes

<sup>1</sup> See Securities Exchange Act Release No. 38240 (February 5, 1997), 62 FR 6290 (February 11, 1997).

<sup>2</sup> A short sale is a sale of a security which the seller does not own or any sale which is con-

summated by the delivery of a security borrowed by, or for the account of, the seller.

<sup>3</sup> 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. To effect a “legal” short sale on a down bid, the short sale must be executed at a price at least 1/16th of a point above the current inside bid. Conversely, if the security’s symbol has a green, up arrow next to it, members can effect short sales in the security without any restrictions.

<sup>4</sup> To be a PMM, a Market Maker had to satisfy at least two of the following four criteria: (1) the Market Maker had to be at the best bid or best offer as shown on Nasdaq no less than 35 percent of the time; (2) the Market Maker had to 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 could occur without being accompanied by a trade execution of at least one unit of trading; or (4) the Market Maker had to execute 1 1/2 times its “proportionate” volume in the stock.

<sup>5</sup> See Securities Exchange Act Release No. 38294 (February 14, 1997), 62 FR 8289 (February 24, 1997).

<sup>6</sup> See Securities Exchange Act Release No. 27938 (April 23, 1990), 55 FR 17949, 17950.

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