SPECIAL NASD NOTICE TO MEMBERS 94-67

NASD Solicits Member Comment On Cash And Non-Cash Compensation For Selling Investment Company And Variable Contract Securities; **Comment Period Expires October 3, 1994**

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Executive Summary

The NASD requests member comment on proposed amendments to Article III, Sections 26 and 29 of the Rules of Fair Practice that would revise existing rules applicable to the sale of investment company securities and establish new rules applicable to the sale of variable contract securities. In connection with the sale of investment company and variable contract securities, the proposed amendments would: (1) prohibit, with certain exceptions, members and associated persons from accepting any non-cash compensation from an investment or insurance company or another member; (2) prohibit associated persons from receiving any compensation from anyone other than the member with which the person is associated, unless permitted by the rule; (3) prohibit receipt by a member of cash compensation from the offeror unless such arrangement is described in the current prospectus; and (4) require that members maintain records of compensation received from offerors. The amendments also would retain the prohibition, in connection with the sale of investment company securities, against a member receiving compensation in the form of securities from an offeror.

The exceptions from the non-cash compensation prohibition would permit: (1) in-house sales incentive programs for a broker/dealer's associated persons; (2) sales incentive programs of mutual funds and insurance companies for the associated persons of a broker/dealer subsidiary; (3) payment or reimbursement for training and education meetings held by a broker/dealer or a mutual fund or insurance company for associated persons of broker/dealers; (4) gifts of up to $100 per associated person annually; and (5) an occasional meal, ticket to a sporting event or theater, or entertainment for associated persons and their guests. The text of the proposed amendments and an addendum containing background information on the proposals follows this Notice.

Background

The NASD is requesting comment on proposed amendments to Article III, Sections 26 and 29 of the Rules of Fair Practice that would, among other things, prohibit the receipt of non-cash items of compensation (with certain exceptions) in connection with the sale of investment company and variable contract securities. The current requirements of Subsection 26(l) regulate the disclosure and form of dealer concessions between underwriters and retail dealers of investment company securities (Investment Company Rule). These provisions prohibit dealer concessions in the form of securities, and the payment of concessions directly to associated persons of a member. The provisions also set forth requirements regarding the disclosure of compensation arrangements between underwriters and dealers in the investment company's prospectus.[1] In comparison, Article III, Section 29 currently does not contain similar regulations for sales of variable contract securities (Variable Contracts Rule). Thus, the proposed amendments to the Investment Company Rule would modify current requirements and the amendments to the Variable Contracts Rule would establish new requirements that address compensation arrangements between an investment or insurance company

[1] In *Notice to Members 94-14* (March 1994), the NASD clarified the obligations of members in complying with the compensation disclosure requirements for mutual funds in Subsection 26(l)(1)(C) to Article III of the Rules of Fair Practice. *See*, also, *Notice to Members 94-41* (May 1994).

and any member participating in the distribution of the company's securities.

The Investment Companies and Insurance Affiliated Member Committees of the NASD have each considered the current environment in which investment company and variable contract securities are sold. The Committees did not find that the manner in which non-cash compensation is offered and paid to members and their associated persons indicates a level of supervisory and compliance problems similar to those present in the sale of direct participation program securities (DPPs) which led the NASD to prohibit non-cash compensation in the sale of such securities in 1988.[2] The Committees believe, however, that the increased use of non-cash compensation for the sale of investment company securities heightens the potential for loss of supervisory control over sales practices and increases the possibility for the perception of impropriety, which may result in a loss of investor confidence. The Committees determined, therefore, that limiting non-cash compensation for the sale of investment company securities is appropriate at this time.

Description Of Proposed Amendments

DEFINITIONS

Associated Person of an Underwriter—The definition of the term "associated person of an underwriter" is proposed to be deleted from Subsection (b)(7) to the Investment Company Rule and is incorporated in the proposed new term "offeror," as discussed more fully below. The term encompasses the issuer, the underwriter, the investment adviser to the issuer, and any affiliated person of such entities.

Offeror—The NASD is proposing to define the term "offeror" in the Investment Company Rule to include an investment company, an adviser to an investment company, an underwriter, and any affiliated person of such entities. The term would be defined in the Variable Contracts Rule to include a separate account of an insurance company, an adviser to a separate account of an insurance company, an underwriter, and any affiliated person of such entities. The enumerated entities included in the definition of "offeror" were previously included in the definition of "associated person of an underwriter." The term "affiliated person" is defined in accordance with Section 2(a)(3) of the Investment Company Act of 1940 (1940 Act). The term "underwriter" is defined in Section 2(a)(40) of the 1940 Act and is intended to reference the principal underwriter through which the investment company and insurance company distribute securities to participating dealers for sale to the investor.

Cash Compensation—This term encompasses cash compensation arrangements covered under the current provisions of the Investment Company Rule. The proposed amendments to the Investment Company Rule are intended to be applicable only to those compensation arrangements for the sale of investment company securities that are covered under the current provisions of the Investment Company Rule. The Variable Contracts Rule amendments are proposed to have a similar scope for the sale of variable contract securities.

Non-Cash Compensation—This term encompasses any form of non-cash compensation received by a member or persons associated with a member in connection with the sale and distribution of investment company and variable contract securities, including, but not limited to, merchandise, gifts and prizes, and payment of travel expenses, meals, and lodging. Thus, the definition of "non-cash compensation" encompasses payments of cash to reimburse costs for travel, meals, and lodging incurred by a member or an associated person.

REGULATING CASH AND NON-CASH COMPENSATION

The NASD is proposing to adopt as Section (l) of the Investment Company Rule and Section (h) of the Variable Contracts Rule new provisions governing the receipt of cash and non-cash compensation by members and associated persons. The proposed amendments would apply to both variable annuity and variable life products under the Variable Contracts Rule. As to the Investment Company Rule, the proposed amendments would apply to securities sales of an investment company registered under the 1940 Act. Thus, the proposed rules would apply to securities sales by a face-amount certificate company, a unit investment trust, and open- and closed-end management companies. Closed-end management companies are also regulated under Article III, Section 44 of the Rules of Fair Practice, and the receipt of non-cash compensation is prohibited under Subsection (c)(6)(ix) of that rule.[3]

The preamble to the new provisions provides that such compensation must be received "in connection with

[2]For a detailed discussion of the background of the proposed amendments, please call Carolyn Thrower, Advertising/Investment Companies Regulation, at (202) 728-6977.

[3]*See*, Sections 3, 4, and 5 of the 1940 Act. Section (b)(8)(C) to Article III, Section 44 of the Rules of Fair Practice provides an exemption from compliance with Section 44 for securities of investment companies registered under the Investment Company Act of 1940, except for securities of a closed-end management company as defined in Section 5(a)(2) of the 1940 Act.

the sale and distribution" of investment company or variable contract securities, as applicable. The NASD is aware that members and their associated persons receive compensation for the sale of non-securities products from insurance companies and receive other forms of payments from investment and insurance companies that are not for sales and distribution activities. The preamble is intended to clarify that the provisions only relate to cash and non-cash compensation received in connection with the sale and distribution of the security covered by the rule.

Limitation on Receipt of Compensation by Associated Persons—The NASD is proposing in new Subsection (l)(1) of the Investment Company Rule and new Subsection (h)(1) of the Variable Contracts Rule to prohibit an associated person from accepting any compensation from any person other than the member with which the person is associated, except as permitted elsewhere in the proposed rule.

Ministerial Exception to Limitation on Receipt of Compensation by Associated Persons—The second proposed sentence of new Subsection (l)(1) of the Investment Company Rule and new Subsection (h)(1) of the Variable Contracts Rule clarifies that the prohibition on receipt of compensation by an associated person from any person other than the member with which the person is associated does not prohibit arrangements, agreed to by a member, where an investment or insurance company maintains a commission account as a ministerial service for a member and pays commission checks from the account directly to the member's associated persons. This exception is intended to recognize current practice in the insurance industry, and reflects the view of the Securities and Exchange Commission (SEC) in Securities Exchange Act Rel. No. 34-8389 (August 29, 1968) (Release 8389) that under certain circumstances such commission payments to associated persons may be made by a life insurance company acting for a subsidiary broker/dealer.[4] The NASD is proposing that the same exception recognize other SEC no-action letters that permit an insurance company to establish a commission account as a ministerial service to make payments of commission overrides for sales of insurance and investment company securities products.[5]

NASD staff also recognizes that the SEC has issued a number of no-action letters permitting, inter alia, associated persons to receive compensation for the sale of variable contract products from a licensed corporate insurance agent acting for one or more insurance companies.[6] The NASD believes it would be appropriate to permit reliance on the NASD's ministerial exception, so long as there is a legitimate state law impediment that prevents an insurance company or its licensed corporate insurance agent from making payments of compensation for the sale of variable contract products directly to the broker/dealer entity and the arrangement otherwise complies with the terms of an appropriate SEC no-action letter.[7] To the extent that an arrangement proposed by a member to rely on the ministerial exception does not appear to come within the parameters of Release 8389 or an applicable no-action letter previously issued by the SEC, the NASD recommends that members request a no-action position from the staff of the Division of Market Regulation of the SEC.

The NASD requests comment on whether (1) there are other situations, not discussed above, where the SEC has issued interpretive or no-action positions on payments of commissions directly to associated persons, and (2) the language of the ministerial exception appropriately encompasses the situations discussed above and any other situations where commissions may be paid directly to associated persons pursuant to SEC interpretive or non-action positions.

[4]Release 8389 states that the SEC would not recommend enforcement action where the insurance company makes payments directly to its life insurance agents who are also persons associated with the insurance company's subsidiary broker/dealer, so long as: (1) such payments are made as a purely ministerial service and are properly reflected on the books and records of the broker/dealer; (2) a binding agreement exists between the insurance company and the broker/dealer that all books and records are maintained by the insurance company as agent for the broker/dealer and are preserved in conformity with the requirements of Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934; (4) all such books and records are subject to inspection by the SEC in accordance with Section 17(a) of the Exchange Act; and (5) the subsidiary broker/dealer has assumed full responsibility for the securities activities of all persons engaged directly or indirectly in the variable annuity operation.

[5]*See*, e.g., SEC No-Action Letter to The Mutual Benefit Life Insurance Company (publicly available January 21, 1985) and other SEC no-action letters cited therein.

[6]*See, Traditional Equinet*, publicly available January 8, 1992; and *Mariner Financial Services*, publicly available December 16, 1988, which include references to other SEC no-action letters in the incoming letters requesting the SEC no-action position.

[7]Thus, to rely on an SEC no-action letter, there must be state law impediments that satisfy either category (1) or (2) and also satisfy category (3). Regardless of whether a state law impediment exists, an insurance company may rely on Release 8389 to establish a ministerial account where an insurance company makes commission payments directly to associated persons of its subsidiary broker/dealer makes commission payments.

Securities As Compensation—The NASD will retain the provision currently in Subsection (l)(1)(A) that prohibits members and their associated persons from receiving compensation in the form of securities of any kind. The NASD proposes that this provision be renumbered as new Subsection (l) (2) of the Investment Company Rule.

Recordkeeping Requirement—The NASD is proposing to adopt as new Subsection (l)(3) of the Investment Company Rule and Subsection (h)(2) of the Variable Contracts Rule the general requirement that members must maintain records of all compensation, cash and non-cash, received from offerors. The records are required to include the names of the offerors, the names of the associated persons, and the amount of cash and/or the nature of non-cash compensation received. Two exceptions are provided to the recordkeeping requirement, as described in Subsection (l)(5)(a) and (b) of the Investment Company Rule and Subsection (h)(5)(a) and (b) of the Variable Contracts Rule. These arrangements are discussed below as they are also exceptions to the prohibition on non-cash compensation.

Prospectus Disclosure of Cash Compensation—Newly numbered Subsection (l)(4) in the Investment Company Rule preserves the requirement currently in Subsection (l)(1)(C) prohibiting acceptance of compensation by a member from an offeror unless such compensation is disclosed in the prospectus. In the case where special cash compensation arrangements are made available by an offeror to a member, but are not available on the same terms to all members to distribute the securities, the disclosure shall include the name of the recipient member and the details of the special arrangements. The provision has been modified to reference only "cash compensation" because non-cash compensation is proposed to be prohibited in a manner that would not require disclosure of any such non-cash compensation.

Exceptions From Prospectus Disclosure Requirement—The NASD is proposing an additional exception from the prospectus disclosure requirement in proposed Subsection (l)(4) in the Investment Company Rule and proposed Subsection (h)(3) in the Variable Contracts Rule. The first two exceptions in paragraphs (a) and (b) incorporate current Subsections (l)(4)(A) and (B) of the Investment Company Rule, with minor language changes for clarification. These two provisions provide an exception from disclosure for compensation arrangements between: (1) principal underwriters of the same security; and (2) the principal underwriter of a security and the sponsor of a unit investment trust that utilizes such security as its underlying investment. By their terms, these provisions describe arrangements that would not trigger the proposed recordkeeping requirements.

The additional exception being proposed is contained in paragraph (c), and excepts from the prospectus disclosure requirement compensation arrangements between a non-member company and its sales personnel who are registered representatives of an NASD member that directly or indirectly controls, is controlled by, or is under common control with, the non-member company. The purpose of this exception is to permit an investment or insurance company to provide cash compensation to the employees of an NASD member firm with which it has a control relationship without the need to disclose such arrangements. Regardless of the exception, however, the member is required to comply with the recordkeeping requirements of the proposed rule for compensation received from a non-member company. As the prospectus disclosure provision is only related to compensation **received** by a member from an offeror, it is not necessary to provide an exception for the in-house compensation paid by a member to its own associated persons.

Prohibition on Non-Cash Compensation—The NASD is proposing to adopt as new Subsection (l)(5) to the Investment Company Rule and Subsection (h)(4) to the Variable Contracts Rule a prohibition on non-cash compensation. The new provision prohibits a member or an associated person from directly or indirectly accepting any non-cash compensation offered or provided to such member or its associated persons unless such non-cash compensation is permitted under another provision.

Exceptions From Non-Cash Compensation, Recordkeeping, and Direct Payment Prohibitions for Gifts and Entertainment—Proposed Subsection (l)(5) to the Investment Company Rule and Subsection (h)(4) to the Variable Contracts Rule include two exceptions for gifts and entertainment, which may be paid directly to an associated person and, as non-cash items, do not have to be disclosed in the prospectus. Additionally, these two forms of non-cash compensation are specifically excepted from the recordkeeping requirement of the proposed rule.

Proposed Subsections (l)(5)(a) and (b) to the Investment Company Rule and Subsections (h)(4)(a) and (b) of the Variable Contracts Rule provide that, so long as such compensation is not provided as a precondition or an incentive to sell, the following items are excepted from the prospectus disclosure requirement and an associated person may accept them from a person other than the member-employer: (1) gifts that do not exceed

an annual amount per person fixed periodically by the Board of Governors, which is currently $100 per person; and (2) an occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of impropriety. The latter exception has been revised from the current language to reflect that entertainment for associated persons will usually include a spouse or guest of the person and that payment for a guest is permissible.

The current requirement that such entertainment "not be conditioned on sales of shares of investment companies" and that gifts of up to $100 be "unconditional" was replaced by the requirement that the entertainment or gift "not be provided or offered as an incentive to sell." The revised language is intended to clarify that such gifts and entertainment are permitted to be provided as rewards, for example, for past sales, but shall not be part of an incentive program or plan which requires that the recipient reach a specific sales goal to receive the entertainment or gift. It is believed that the revised language permits the continuation of normal business practices, while preventing an investment or insurance company from providing the gift or entertainment as part of a non-cash sales incentive program.

Exception From Non-Cash Compensation Prohibition For Training And Education Meetings—The NASD is proposing an exception for training and education meetings to the prohibition on non-cash compensation as Subsection (l)(5)(c) of the Investment Company Rule and Subsection (h)(4)(c) of the Variable Contracts Rule. The proposed exception would, under certain circumstances, permit payment or reimbursement by offerors for meetings held by the offeror or by a member for the purpose of training or educating associated persons. This provision is intended to continue to permit members and offerors to hold training and education meetings for associated persons. In the case of a meeting held by a member, it is not unusual for offerors to reimburse certain of the member's expenses related to the meeting in exchange for the opportunity to discuss with the member's associated persons a particular training or education topic. In the case of a meeting held by an offeror, the offeror provides an opportunity for associated persons of many members to attend a training and education meeting, so long as attendance is determined by the member firm.

Since the proposed prospectus disclosure provision only requires disclosure of cash compensation, the proposed exception would not trigger the disclosure requirements as payment or reimbursement of expenses by an offeror for a member's training and education meeting is considered to be non-cash compensation. The proposed exception would, however, be subject to the prohibition on an associated person accepting any compensation from anyone other than his or her member-employer.

The limitations imposed on the exception are intended to ensure that the meeting is for the purpose of training and education and is not, in fact, a prohibited non-cash sales incentive trip or entertainment. The payment or reimbursement by offerors for such meetings would be subject to the recordkeeping requirement in order that information on such payments and reimbursements is in the records of the member and, therefore, subject to examination by the NASD. To avoid supervisory problems, associated persons would also be required to obtain the member's prior approval to attend the meeting. Such prior approval would satisfy the prohibition on associated persons accepting any compensation from anyone other than their member-employer. Members should establish a procedure so that their records reflect that appropriate approval has been provided to associated persons in connection with such meetings for review by the NASD.

The location of the meeting must be appropriate to its purpose. A showing of appropriate purpose is demonstrated where the location is the office of the offeror or the member, or a facility located in the vicinity of such office. To address meetings where the attendees are from a number of offices in a region of the country, the meeting location may be in a regional location. The NASD will periodically review the proposed meeting location and agenda to determine whether the meeting is for the purpose of training or education.

The payment or reimbursement by an offeror may also only be applied to the expenses of the member and its associated persons in attending the meeting and shall not be used to defray the expenses of guests of the associated person. Thus, either the member-employer of the associated person or the associated person must pay the expenses of a guest of an associated person attending a training or education meeting. The non-cash sales incentive prohibitions in connection with DPPs in Article III, Section 34 and in connection with REITs and corporate equity and debt in Article III, Section 44 of the Rules of Fair Practice do not include rule language providing a similar exception for training and education meetings. However, the NASD has interpreted those rules to provide a similar exception.[8]

[8] *See*, Securities Exchange Act Rel. No. 26185 (October 14, 1988); 53 FR 41262 (October 20, 1988), footnote 4, at 41263.

Finally, the exception permitting training and education meetings is only available if the payment or reimbursement by the offeror is not conditioned on sales or the promise of sales by the member or its associated persons. This requirement is intended to ensure that the offeror making the payment or reimbursement does not participate in any manner in a member's decision as to which associated persons will attend a member's or offeror's meeting. The provision is not, however, intended to prevent a member from designating persons to attend a meeting held by the member or by an offeror based on sales or any other criteria as deemed appropriate by the member-employer, so long as attendance at the meeting is not earned through a member's in-house sales incentive program. The requirement prohibiting offerors from conditioning payment on sales or the promise of sales should be compared to that applicable to gifts and entertainment which prohibits the offeror from requiring that the recipient meet a specific sales goal.

Exception From Non-Cash Compensation and Direct Payment Prohibitions for In-House Arrangements—The NASD is proposing to adopt as Subsection (l)(6) to the Investment Company Rule and Subsection (h)(5) of the Variable Contracts Rule an exception from the prohibitions on non-cash compensation and direct payments to associated persons for non-cash compensation arrangements between a member and its associated persons and between an investment or insurance company and the sales personnel of a member with which it has a control relationship. This provision is not subject to the proposed disclosure requirements.

In-house payment arrangements, however, are subject to three conditions. They must conform to the recordkeeping requirement, must be multi-product type oriented, and may not involve, directly or indirectly, an unaffiliated investment or insurance company or other member participating in or contributing to such non-cash compensation arrangements.

The phrase "multi-product type" is intended to ensure that in-house non-cash compensation arrangements are not based on the sale of a specifically designated mutual fund or variable contract. That is, for multi-product type firms (e.g., firms selling mutual funds, equity securities, DPPs, variable contracts, corporate bonds, etc.), the non-cash arrangement must be based on the sales of more than one product type. For single-product type firms (e.g., a firm selling only mutual funds or only variable contracts), the rule permits one product type to be the basis for the sales incentive. However, the incentive must be based on the associated person's gross production of all securities within that product type, not on the sales of a specifically designated mutual fund or variable contract.

The prohibition against the involvement of unaffiliated investment or insurance companies or other members is intended to ensure that, except in the narrow areas where non-cash compensation arrangements are permitted, investment and insurance companies and other members do not, by payments of cash to a member or by some other means, participate in or contribute to a permitted non-cash compensation arrangement.

Both the Investment Companies and Insurance Affiliated Members Committees believe that the exception for non-cash compensation arrangements between a member and its associated persons should be equally available in the context of non-cash compensation arrangements between a non-member company and the associated persons of the company's affiliated NASD member firm. This practice, which is codified in Subsection (l)(4)(C) of the Investment Company Rule, has long been permitted in the sale of investment company and variable contract securities products. In both cases, the non-cash compensation arrangement is internal to the employer-employee relationship and, therefore, should not raise the supervisory concerns that are present in the compensation arrangements between a non-member and the unaffiliated broker/dealers selling its product. Moreover, the Committees note that it has generally not been the practice for the NASD to regulate the internal compensation arrangements between a member and its associated persons.

Operation Of Proposed New Rules

To facilitate understanding of the proposed new rules, the NASD is providing examples of different compensation arrangements with an analysis of the applicability of the different provisions of the proposed new rules. References to the provisions of the proposed rules will only be to the amendments proposed to the Investment Company Rule to simplify the discussion.

Examples

Example 1: An offeror holds an overnight educational meeting for associated persons of broker/dealer firms at a location that requires transportation by airplane and includes meals.

Analysis: This arrangement would be permitted if it complies with the requirements of proposed Section (l)(5)(c) of the Investment Company Rule that permits training and education meetings, so long as the member controls the determination of which associated persons will attend the

meeting, the associated persons obtain the member's prior approval to attend the meeting, the location is appropriate to the purpose of the meeting, the payments by the offeror are only for expenses of the associated persons, and the member satisfies the recordkeeping requirements set forth in Subsection (l)(3) of the Investment Company Rule and Subsection (h)(2) of the Variable Contracts Rule.

Example 2: An offeror holds a training or educational meeting for associated persons not affiliated with the offeror. The meeting is more social than business; for example, it is comprised of two to three hours per day of training/educational sessions and the remainder of the day consists of social activities.

Analysis: This arrangement would be prohibited by proposed Section 5 of the Investment Company Rule as non-cash compensation. For an offeror or a member (for persons associated with other members) to provide a training and educational meeting, the arrangements must comply with the exception in proposed Section (l)(5)(c). An offeror is, however, allowed to entertain associated persons of a member, so long as the arrangement complies with proposed Section (1)(5)(b) that assumes there is a meal or entertainment that is not a "meeting," and does not raise any question of impropriety.

Example 3: A broker/dealer holds its annual meeting for its associated persons and their guests, paying all expenses without reimbursement from any offeror not affiliated with the broker/dealer.

Analysis: This arrangement would be permitted by proposed Section (l)(6) of the Investment Company Rule and can be at any location which the member-employer deems appropriate. If attendance at the event is conditioned on the achievement of specified sales goals under an incentive program, the incentive program must meet the requirements of Section (l)(6)(a) that the program must be multi-product type oriented or, if the member is a single-product type firm, must be based on the gross production of associated persons.

Example 4: Same arrangement as Example 3, except that one or more non-member companies not affiliated with the broker/dealer pays for certain of the meeting arrangements or reimburses certain of the broker/dealer's expenses.

Analysis: This arrangement would be permitted under proposed Section (l)(5)(c) of the Investment Company Rule only if the member controls the determination of which associated persons will attend the meeting, the associated persons obtain the member's approval to attend the meeting, the location is appropriate to the purpose of the meeting, the payments by the offeror are only for expenses of the associated persons, and the member satisfies the recordkeeping requirements. While it is the decision of the member to choose who attends the meeting, it may not use an incentive program to determine who attends.

Example 5: Same arrangement as Example 3, except that an affiliated non-member company pays for or reimburses the member's expenses.

Analysis: This arrangement would be permitted under proposed Section (l)(6) of the Investment Company Rule, under the same conditions as set forth in Example 3.

Example 6: An investment or insurance company establishes a program for the payment of a special **cash** incentive bonus for broker/dealers that meet certain specific sales targets.

Analysis: This arrangement would be permitted because the incentive is in the form of cash, subject to the requirements of proposed Sections (l)(1), (3), and (4) of the Investment Company Rule which prohibit payment of the incentive directly to an associated person, require that the member maintain a record of the cash bonus, and require that the special compensation arrangement be described in the current prospectus.

Example 7: An investment or insurance company pays a percentage commission to a broker/dealer for the sale of its securities products. The broker/dealer uses the commission to pay for the expenses of a training or educational meeting for its associated persons.

Analysis: This arrangement would be permitted, subject to compliance with proposed Sections (l)(1), (3), and (4) of the Investment Company Rule. The meeting is not specifically subject to the requirements of proposed Subsection (l)(5)(c) of the Investment Company Rule because (absent a more direct relationship between the payment and the meeting) the commission payment would not be viewed as intended as a payment or reimbursement for the member's in-house educational meeting.

Proposed Implementation Of New Rules

The NASD is proposing that the amendments to the Investment Company and Variable Contracts Rules be implemented to prohibit the initiation of a new non-cash incentive program after the approval of the amendments by the SEC. Thus, if the proposed amendments were approved, for example, on July 1, 1995, no new program could begin from that effective date forward. However, sales that occurred after the July 1 approval date could be

applied to a non-cash incentive program that was already in progress. Therefore, after the July 1, 1995, effective date, members and their associated persons would be permitted to receive non-cash sales incentives earned before that effective date.

The NASD requests comment on the proposed structure of implementation to assist it in developing an appropriate transition methodology that takes into account the structure of non-cash sales incentive programs that are used in the sale of investment company and variable contract securities products.

Request For Comment

The NASD encourages all members and other interested parties to comment on the proposed amendments to Article III, Sections 26 and 29 of the Rules of Fair Practice. Comments should be forwarded to:

Joan C. Conley
Office of the Secretary
NASD
1735 K Street, N.W.
Washington, D.C. 20006-1506

Comments should be received by October 3, 1994.

Questions concerning this Notice should be directed to Clark Hooper, Vice President, Advertising/ Investment Companies Regulation Department, at (202) 728-8325; Suzanne E. Rothwell, Associate General Counsel, Office of General Counsel, at (202) 728-8247; and Robert J. Smith, Attorney, Office of General Counsel, at (202) 728-8176.

Proposed Amendments To Sections 26 And 29 To Article III Of The Rules Of Fair Practice

(**Note:** New text is underlined; deleted text is in brackets.)

Investment Companies

Section 26

Application

(a.) (Unchanged)

Definitions

(b)(1)-(6) (Unchanged.)

(7) ["Associated person of an underwriter" as used in subsection (l) of this section, shall include an issuer for which an underwriter is the sponsor or a principal underwriter, any investment adviser to such issuer, or any affiliated person (as defined in Section 2(a)(3) of the 1940 Act) of such underwriter, issuer or investment advisor.] The terms "offeror," "cash compensation" and "non-cash compensation" as used in Subsection (l) shall have the following meanings:

"Offeror" shall mean an investment company, an adviser to an investment company, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.

"Cash compensation" shall mean any discount, concession, fee, commission, asset-based sales charge, loan, or override received in connection with the sale and distribution of investment company securities.

"Non-cash compensation" shall mean any non-cash form of compensation received in connection with the sale and distribution of investment company securities, including but not limited to merchandise, gifts and prizes, and payment of travel expenses, meals and lodging.

(c) - (k) (Unchanged.)

[Dealer concessions]

[(l)(1) No underwriter or associated person of an underwriter shall offer, pay, or arrange for the offer or payment to any other member, in connection with retail sales or distribution of investment company securities, any discount, concession, fee or commission (hereinafter referred to as "concession") which:]

[(A) is in the form of securities of any kind, including stock, warrants or options;]

[(B) is in a form other than cash (e.g., merchandise or trips), unless the member earning the concession may elect to receive cash at the equivalent of no less than the underwriter's cost of providing the non-cash concession; or]

[(C) is not disclosed in the prospectus of the investment company. If the concessions are not uniformly paid to all dealers purchasing the same dollar amounts of securities from the underwriter, the disclosure shall include a description of the circumstances of any general variations from the standard schedule of concessions. If special compensation arrangements have been made with individual dealers, which arrangements are not generally available to all dealers, the details of the arrangements, and the identities of the dealers, shall also be disclosed.]

[(2) No underwriter or associated person of an underwriter shall offer or pay any concession to an associated person of another member, but shall make such payment only to the member.]

[(3)(A) In connection with retail sales or distribution of investment company shares, no underwriter or associated person of an underwriter

shall offer or pay to any member or associated person, anything of material value, and no member or associated person shall solicit or accept anything of material value, in addition to the concessions disclosed in the prospectus.]

[(B) For purposes of this paragraph (l)(3), items of material value shall include but not be limited to:]

[(i) gifts amounting in value to more than $50 per person per year.]

[(ii) gifts or payments of any kind which are conditioned on the sale of investment company securities.]

[(iii) loans made or guaranteed to a non-controlled member or person associated with a member.]

[(iv) wholesale overrides (commissions) granted to a member on its own retail sales unless the arrangement, as well as the identify of the member, is set forth in the prospectus of the investment company.]

[(v) payment or reimbursement of travel expenses, including overnight lodging, in excess of $50 per person per year unless such payment or reimbursement is in connection with a business meeting, conference or seminar held by an underwriter for informational purposes relative to the fund or funds of its sponsorship and is not conditioned on sales of shares of an investment company. A meeting, conference or seminar shall not be deemed to be of a business nature unless: the person to whom payment or reimbursement is made is personally present at, or is en route to or from, such meeting in each of the days for which payment or reimbursement is made; the person on whose behalf payment or reimbursement is made is engaged in the securities business; and the location and facilities provided are appropriate to the purpose, which would ordinarily mean the sponsor's office.]

[(C) For purposes of this paragraph (l)(3), items of material value shall not include:]

[(i) an occasional dinner, a ticket to a sporting event or the theater, or comparable entertainment of one or more registered representatives which is not conditioned on sales of shares of an investment company and is neither so frequent nor so extensive as to raise any question of propriety.]

[(ii) a breakfast, luncheon, dinner, reception or cocktail party given for a group of registered representatives in conjunction with a bona fide business or sales meeting, whether at the headquarters of a fund or its underwriter or in some other city.]

[(iii) an unconditional gift of a typical item of reminder advertising such as a ballpoint pen with the name of the advertiser inscribed, a calendar pad, or other gifts amounting in value to not more than $50 per person per year.]

[(4) The provisions of this subsection (l) shall not apply to:]

[(A) Contracts between principal underwriters of the same security.]

[(B) Contracts between principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.]

[(C) Compensation arrangements of an underwriter or sponsor with its own sales personnel.]

Member Compensation

(l) In connection with the sale and distribution of investment company securities:

(1) Except as described below, no associated person of a member shall accept any compensation, cash or non-cash, from anyone other than the member with which the person is associated. This requirement will not prohibit arrangements, agreed to by a member, where an insurance company maintains a commission account as a ministerial service for a member and, on behalf of the member, pays commission checks from such an account directly to associated persons of the member.

(2) No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.

(3) Except for items described in Subsection (l)(5)(a) and (b), a member shall maintain records of all compensation, cash and non-cash, received from offerors. The records shall include the names of the offerors, the names of the associated persons and the amount of cash and/or the nature of non-cash compensation received.

(4) No member shall accept any cash compensation from an offeror unless such compensation is described in the current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus. Prospectus disclosure requirements shall not apply to cash compensation arrangements between:

(a) principal underwriters of the same security;

(b) the principal underwriter of a

security and the sponsor of a unit investment trust which utilizes such security as its underlying investment; and

(c) a non-member company and its sales personnel who are associated persons of an NASD member which, directly or indirectly controls, is controlled by, or is under common control with that non-member company provided that the recordkeeping requirement in Subsection (l)(3) is satisfied.

(5) No member or person associated with a member shall directly or indirectly accept any non-cash compensation offered or provided to such member or its associated persons. Notwithstanding the foregoing prohibition and the provisions of Subsection (l)(1), the following items of non-cash compensation may be accepted:

(a) Gifts to associated persons of members that do not exceed an annual amount per person fixed periodically by the Board of Governors[9] and are not preconditioned on achievement of a specified sales target.

(b) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a specified sales target.

(c) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) the recordkeeping requirement in Subsection (l)(3) is satisfied;

(ii) associated persons obtain the member's prior approval to attend the meeting; (iii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iv) the payment or reimbursement is only applied to the expenses of the member and persons associated with the member in attending the meeting, which shall not include guests of the associated person; and

(v) the payment or reimbursement by the offeror is not conditioned on sales or the promise of sales by the member or persons associated with the member.

(6) Notwithstanding the prohibition in Section (5), non-cash compensation arrangements are permissible between a member and its associated persons or a non-member company and its sales personnel who are associated persons of a member which, directly or indirectly controls, is controlled by, or is under common control with that non-member company, provided that:

(a) the member's or non-member's non-cash compensation arrangement is multi-product type oriented, or, for single-product type firms, based on the gross production of the associated person;

(b) no unaffiliated non-member company or other member directly or indirectly participates in or contributes to such non-cash compensation arrangements; and

(c) the recordkeeping requirement in Subsection (l)(3) is satisfied.

* * *

Variable Contracts Of An Insurance Company

Section 29

(a) (Unchanged.)

Definitions

(b)(1) - (2) (Unchanged.)

(3) The terms "offeror," "cash compensation" and "non-cash compensation" as used in Subsection (h) shall have the following meanings:

"Offeror" shall mean a separate account of an insurance company, an adviser to a separate account of an insurance company, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.

"Cash compensation" shall mean any discount, concession, fee, commission, asset-based sales charge, loan or override received in connection with the sale and distribution of variable contracts.

"Non-cash compensation" shall mean any form of non-cash compensation received in connection with the sale and distribution of variable contracts, including but not limited to merchandise, gifts and prizes, and payment of travel expenses, meals and lodging.

(c) - (g) (Unchanged.)

Member Compensation

(h) In connection with the sale and distribution of variable contracts:

(1) Except as described below, no associated person of a member shall accept any compensation, cash or non-cash, from anyone other than the member with which the person is

[9]The current annual amount fixed by the Board of Governors is $100.

associated. This requirement will not prohibit arrangements, agreed to by a member, where an insurance company maintains a commission account as a ministerial service for a member and, on behalf of the member, pays commission checks from such an account directly to associated persons of the member.

(2) Except for items as described in Subsection (h)(4)(a) and (b), a member shall maintain records of all compensation, cash and non-cash, received from offerors. The records shall include the names of the offerors, the names of the associated persons and the amount of cash and/or the nature of non-cash compensation received.

(3) No member shall accept any cash compensation from an offeror unless such compensation is described in the current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus. Prospectus disclosure requirements shall not apply to cash compensation arrangements between:

(a) principal underwriters of the same security;

(b) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment; and

(c) a non-member company and its sales personnel who are associated persons of an NASD member which, directly or indirectly controls, is controlled by, or is under common control with that non-member company provided that the recordkeeping requirement in Subsection (h)(3) is satisfied.

(4) No member or person associated with a member shall directly or indirectly accept any non-cash compensation offered or provided to such member or its associated persons. Notwithstanding the foregoing prohibition and the provisions of Subsection (h)(1), the following items of non-cash compensation may be accepted:

(a) Gifts to associated persons of members that do not exceed an annual amount per person fixed periodically by the Board of Governors[10] and are not preconditioned on achievement of a specified sales target.

(b) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a specified sales target.

(c) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) the recordkeeping requirement in Subsection (h)(2) is satisfied;

(ii) associated persons obtain the member's prior approval to attend the meeting;

(iii) the location is appropriate to the purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iv) the payment or reimbursement is only applied to the expenses of the member and persons associated with the member in attending the meeting, which shall not include guests of the associated person; and

(v) the payment or reimbursement by the offeror is not conditioned on sales or the promise of sales by the member or persons associated with the member.

(5) Notwithstanding the prohibition in Section (4), non-cash compensation arrangements are permissible between a member and its associated persons or a non-member company and its sales personnel who are associated persons of a member which, directly or indirectly controls, is controlled by, or is under common control with that non-member company, provided that:

(a) the member's or non-member's non-cash compensation arrangement is multi-product type oriented, or, for single-product type firms, based on the gross production of the associated person;

(b) no unaffiliated non-member company or other member directly or indirectly participates in or contributes to such non-cash compensation arrangements; and

(c) the recordkeeping requirement in Subsection (h)(2) is satisfied.

* * *

[10] The current annual amount fixed by the Board of Governors is $100.

SPECIAL NASD NOTICE TO MEMBERS 94-68

SEC Approves Short-Sale Rule For The Nasdaq Stock Market

Suggested Routing

- [x] Senior Management
- [ ] Advertising
- [ ] Corporate Finance
- [ ] Government Securities
- [x] Institutional
- [ ] Internal Audit
- [x] Legal & Compliance
- [ ] Municipal
- [ ] Mutual Fund
- [x] Operations
- [ ] Options
- [ ] Registration
- [ ] Research
- [ ] Syndicate
- [x] Systems
- [x] Trading
- [ ] Training

Executive Summary

On June 29, 1994, the Securities and Exchange Commission (SEC) approved a new short-sale rule for Nasdaq National Market® securities traded on The Nasdaq Stock Market℠ (Nasdaq). The rule takes **effect September 6, 1994,** for an 18-month pilot period.

The Nasdaq® short-sale rule prohibits member firms from effecting short sales at or below the current inside bid as disseminated by Nasdaq whenever that bid is lower than the previous inside bid.[1] The rule will be in effect during normal domestic market hours (9:30 a.m. to 4 p.m., Eastern Time). During the first year the rule is in effect, Nasdaq market makers who have maintained quotations in a particular Nasdaq National Market security for 20 consecutive business days without interruption will be exempt from the rule for short sales in that security, provided all exempted short sales are made in connection with bona fide market-making activity. **Effective September 6, 1995**, the "20-day" test for exemption of Nasdaq market makers will be replaced with a multi-part quantitative test.

The rule also contains certain limited exemptions for options market makers and warrant market makers as well as exemptions similar to those provided under the SEC's short-sale rule for exchange-listed securities, Rule 10a-1. In addition, there are three interpretations to the rule that address: (1) what constitutes "bona fide" market-making activity; (2) the prices at which "legal" short sales may be effected; and (3) examples of specific conduct that will be deemed to violate the rule. In conjunction with adoption of the rule, the NASD also amended the rules for Nasdaq's Automated Confirmation Transaction Service (ACT℠) to require members to append a short-sale identifier to their ACT trade reports for certain short sales.

The implementation of a short-sale rule for Nasdaq National Market securities reflects the ongoing effort of the NASD and The Nasdaq Stock Market, Inc., to ensure investor protection and the integrity of The Nasdaq Stock Market. Adoption of a short-sale rule also will prevent abusive short selling and enhance the quality of the Nasdaq market for investors and issuers.

The NASD hopes this Notice helps members understand the new obligations that will apply to them after September 6, 1994. The NASD also recognizes that additional assistance may be needed to respond to specific areas of concern to the membership. Inquiries should be directed to the staff members listed after the "Questions and Answers" section below.

Description Of The Rule

Nasdaq's short-sale rule prohibits short sales in Nasdaq National Market securities at or below the inside bid when the current inside bid is below the previous inside bid. Nasdaq calculates the inside or best bid from all market makers in the security (including bids for 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" so that members will have that information at their fingertips when effecting short sales. Specifically, an "up bid" is denoted by a green "up" arrow symbol and a "down bid" is denoted by a red "down" arrow. Accordingly,

[1] A short sale is a sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.

absent an exemption from the rule, a member cannot effect a short sale at or below the inside bid in a security in its proprietary account or an account of a customer if there is a red down 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 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.

To determine whether a sale is long or short, members must adhere to the definition of a "short sale" contained in SEC Rule 3b-3, which is incorporated into Nasdaq's short-sale rule. Under SEC Rule 3b-3, the term "short sale" means any sale of a security that the seller does not own or any sale that is consummated by the delivery of a security borrowed by, or for the account of, the seller.[2] To determine whether the seller is long or short overall, the seller must net all positions in the security, just as is required in short sales for exchange-listed securities.

Following is a description of the exemptions to the rule and other significant provisions of the rule. The full text of the short-sale rule follows the "Questions and Answers" section below.

Qualified Market-Maker Exemption

To ensure that market-making activities providing liquidity and continuity to the market are not adversely constrained by implementation of the short-sale rule, 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. If a market maker does not satisfy the requirements for a qualified market maker, it would remain a Nasdaq market maker, however, it could not take advantage of the exemption from the rule. During the first year the rule is in effect, a "qualified" Nasdaq market maker is defined to be a registered market maker that has entered quotations in the relevant security into Nasdaq on an uninterrupted basis for the preceding 20 business days. On the first day of the short-sale rule's implementation, all market makers will be "grandfathered"and considered qualified market makers. Thereafter, market makers that register and begin quoting a Nasdaq National Market issue must wait 20 business days before becoming a qualified market maker. Each market maker is then qualified on the 21st day.

During the last six months of the pilot period for the rule (September 6, 1995, to March 5, 1996) a "qualified" market maker must satisfy the criteria for a "Primary Nasdaq Market Maker" found in new Section 49 of Article III of the NASD Rules of Fair Practice. To qualify as a Primary Nasdaq market maker, market makers must satisfy at least two of the following four criteria:[3]

- The market maker must be at the best bid or best offer as displayed in Nasdaq no less than 35 percent of the time.

- The market maker must maintain a spread no greater than 102 percent of the average dealer spread.

- No more than 50 percent of the market maker's quotation updates may occur without being accompanied by a trade execution of at least one unit of trading.

- The market maker executes one and a half times its "proportionate" volume in the stock.[4]

The review period for satisfaction of the Primary Nasdaq market maker performance standards is one calendar month. If a Primary Nasdaq market maker has not satisfied the threshold standards after a particular review period, the Primary Nasdaq market maker designation will be removed commencing on the next business day following notice of failure to comply with the standards. Market makers may requalify for designation as a Primary Nasdaq market maker by satisfying the threshold standards for the next review period. It is important to note that the Primary Nasdaq market maker standards will go into effect on September 6, 1995, and market makers will have to satisfy the new standards during August 1995 to be eligible for designation as a Primary

[2] A person is deemed to own a security if: (1) he or his agent has title to it; (2) he has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it; (3) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; (4) he has an option to purchase or acquire it and has exercised such option; (5) he has rights or warrants to subscribe to it and has exercised such rights or warrants.

[3] In response to concerns raised by the Securities Traders Association and certain member firms, the NASD has indicated its willingness to consider alternative standards which may more effectively identify those market makers that make a significant contribution to the market for a Nasdaq stock. While, to date, none have been suggested, NASD staff continues to be willing to consider alternative standards advanced by industry participants.

[4] For example, if there are 10 market makers in a stock, each dealer's proportionate share volume would be 10 percent; therefore, one and a half times proportionate share volume would mean 15 percent of overall volume.

Nasdaq market maker on September 6, 1995.

Qualified Market-Maker Registration

In An Existing Nasdaq Security
Phase I (September 6, 1994, to September 6, 1995) During this period a market maker seeking to become a qualified market maker in an existing Nasdaq National Market security must maintain, without interruption, quotations in the security for the preceding 20 business days. On September 6, 1994, however, all market makers will be "grandfathered" and considered qualified market makers. Thereafter, market makers that register and begin quoting a Nasdaq National Market issue must wait 20 business days before becoming a qualified market maker. Each market maker is then qualified on the 21st day.

Phase II (September 6, 1995, to March 5, 1996) During this period, if a market maker is a Primary Nasdaq market maker in 80 percent or more of the securities in which it has registered, it may immediately become a Primary Nasdaq market maker (i.e., a qualified market maker) in a Nasdaq National Market security by registering and entering quotations in that issue. If the market maker is not a Primary Nasdaq market maker in at least 80 percent of its stocks, it may qualify as a Primary Nasdaq market maker in that stock if the market maker registers in the stock but does not enter quotes for five days or the market maker registers in the stock as a regular Nasdaq market maker and satisfies the qualification criteria for the next review period.

In Initial Public Offerings (IPOs)
Phase I (September 6, 1994, to September 5, 1995) During this period, a market maker may immediately become a qualified market maker in an IPO by immediately registering and entering quotations in the issue. However, if the market maker withdraws from the security on an unexcused basis within the first 20 calendar days after the offering, it will not be eligible for designation as a qualified market maker in any subsequent IPO for the next 10 business days following the unexcused withdrawal.

Phase II (September 6, 1995, to March 5, 1996) During this period, a market maker may immediately become a Primary Nasdaq market maker (i.e., qualified market maker) in an IPO issue by immediately registering and entering quotations in the issue, provided it has obtained Primary Nasdaq market maker status in 80 percent or more of the stocks in which it has registered. However, if at the end of the first review period a market maker has failed to satisfy the qualification criteria or has withdrawn on an unexcused basis from the security, it is prohibited from becoming a Primary Nasdaq market maker in any other IPO for the next 10 business days.

In Secondary Offerings
Phase I (September 6, 1994, to September 5, 1995) During this period, unless a market maker was registered in a security before a secondary offering in that stock has been publicly announced or a registration statement has been filed, it cannot become a qualified market maker in the stock unless the secondary offering has become effective and the market maker has been registered in the security and maintained quotations without interruption for 40 calendar days.

Phase II (September 6, 1995, to March 5, 1996) During this period, unless a market maker was registered in a security before a secondary offering in that stock has been publicly announced or a registration statement has been filed, it cannot become a Primary Nasdaq market maker, (i.e., a qualified market maker) in the stock unless the secondary offering has become effective and the market maker has satisfied the Primary Nasdaq market maker qualification criteria between the time the market maker registered in the security and the time the offering became effective or the market maker has satisfied the Primary Nasdaq market maker qualification standards for 40 calendar days.

In Merger And Acquisition Situations
Phase I (September 6, 1994, to September 5, 1995) During this period, after a merger or acquisition involving an exchange of stock has been publicly announced and not yet consummated or terminated, a market maker may register and begin entering quotations in either or both of the two affected securities and immediately become a qualified market maker in either or both of the issues. However, if the market maker withdraws on an unexcused basis from any stock in which it has so registered within 20 calendar days, the market maker will not be eligible for immediate designation as a qualified market maker for any merger or acquisition announced within three months after the unexcused withdrawal.

Phase II (September 6, 1995, to March 5, 1996) During this period, after a merger or acquisition is announced, a Primary Nasdaq market maker in one stock may immediately become a Primary Nasdaq market maker in the other stock by registering and entering quotations in that issue.

Exemptions Comparable To Those In SEC Rule 10a-1

To reduce compliance burdens for members, Nasdaq's short-sale rule

incorporates the exemptions in SEC Rule 10a-1 that are relevant to trading in the Nasdaq market. Specifically the rule exempts:

• Sales by a broker/dealer for an account in which it has no interest and that are marked long.

• Sales by a market maker to offset odd-lot orders of customers.

• Sales by any person, for an account in which he has an interest, if such person owns the security sold and intends to deliver such securities as soon as possible without undo inconvenience or expense.

• Sales by a member to liquidate a long position that is less than a round lot, provided the sale does not change the member's position by more than one unit of trading (100 shares).

• Short sales effected by a person in a special arbitrage account if the person effecting the short sale then owns another security by virtue of which the person is, or presently will be, entitled to acquire an equivalent number of securities of the same class of securities sold; provided such sale, or the purchase that such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such class of securities of the issuer.

• Short sales effected by a person in a special international arbitrage account for the bona fide purpose of profiting from a current difference between the price of such security on a securities market not within or subject to the jurisdiction of the United States and on such a securities market subject to the jurisdiction of the United States; provided the person at the time of such sale knows or, by virtue of information currently received, has reasonable grounds to believe that an offering enabling a person to cover such sale is then available to the person in such foreign securities markets and intends to accept such offer immediately.

• Short sales by an underwriter or any member of the distribution syndicate in the over-allotment of securities, or any lay-off sale by such a person in a distribution of securities rights pursuant to SEC Rule 10b-8 or a stand-by underwriting commitment.

The rule also provides that a member not currently registered as a market maker in a security it has acquired while acting as a block positioner will be deemed to own the security for the purposes of the rule. Thus, even if such member may not have a net long position in such security, the rule would not apply if and to the extent that such member's short position in such security is subject to one or more offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities. In addition, the NASD recognizes that an SEC staff interpretation to SEC Rule 10a-1 dealing with the liquidation of index arbitrage positions is equally applicable to Nasdaq's short-sale rule.[5] Further, the NASD recognizes that an SEC staff no-action position with respect to SEC Rule 10a-1 dealing with an "international equalizing exemption" for exchange-listed foreign securities and American Depositary Receipts (ADRs) applies equally to Nasdaq's short-sale rule.[6] Specifically, the NASD has interpreted its short-sale rule to provide that any person can sell a foreign security, or a depositary share or depositary receipt relating to such a security, on a down bid at the opening, provided the inside bid is equal to or above the last reported sale price (adjusted for current exchange rates and ADR multiples) of that security in the principal foreign market for the security.

Options Market-Maker Exemption
An NASD member may execute a short sale for the account of an equity option market maker or an index option market maker that would otherwise violate the Nasdaq short-sale rule so long as the short sale is an "exempt hedge transaction" and the options market maker is registered with a "qualified options exchange" as a "qualified options market maker" in a stock options class on a Nasdaq National Market security or in an options class on a "qualified" stock index. The NASD notes, however, that an NASD member would not be in violation of the Nasdaq short-sale rule if it executed an order for the account of an options market maker in the good faith belief that the order was in full compliance with the Nasdaq short-sale rule and it was subsequently determined that the order was either not entitled to the exemption or it was incorrectly marked long.

For equity option market makers, an "exempt hedge transaction" is defined as a short sale that was effected to hedge, and in fact serves to hedge, an existing offsetting options position or an offsetting options position created in a transaction(s) that was contemporaneous with the short sale,[7] provided that when establishing the short position the options market maker receives, or

[5] In 1986, the SEC took a "no-action" position that allows broker/dealers to sell short on a down tick while liquidating index arbitrage positions under certain conditions. This no-action position was clarified in a later SEC Release and the SEC has proposed to amend Rule 10a-1 to incorporate this interpretation. *See* Securities Exchange Act Release No. 30772 (June 3, 1992) 57 FR 24415.

[6] *Id* 57 FR 24418.

[7] The phrase contemporaneously established

is eligible to receive, good faith margin pursuant to Section 220.12 of Regulation T under the Securities Exchange Act of 1934.

For index option market makers, an "exempt hedge transaction" is defined as a short sale in a Nasdaq National Market security that was effected to hedge, and in fact serves to hedge, an existing offsetting stock index options position or an offsetting stock index options position created in a transaction(s) that was contemporaneous with the short sale, provided certain conditions are satisfied. These conditions are as follows: the security sold short must be a component security of the index underlying such index option; the index underlying such offsetting index options position must be a "qualified stock index"; and the dollar value of all exempt short sales effected to hedge the offsetting stock index options position(s) does not exceed the aggregate current index value of the offsetting options position(s). A "qualified stock index" is defined as a stock index that includes one or more Nasdaq National Market securities, provided that more than 10 percent of the weight of the index is accounted for by Nasdaq National Market securities. In addition, qualified stock indexes will be reviewed as of the end of each calendar quarter, and the index will cease to qualify if the value of the index represented by one or more Nasdaq National Market securities is less than 8 percent at the end of any subsequent calendar quarter.

Any short sale unrelated to normal options market-making activity, such as index arbitrage or risk arbitrage that in either case is independent of an options market maker's market-making functions, however, will not be considered an "exempt hedge transaction."

A "qualified options exchange" is defined as a national securities exchange that has received SEC approval of its rules and procedures governing: the designation of options market makers as qualified options market makers; the surveillance of its market makers' utilization of the exemption; and authorization of the NASD to withdraw, suspend, or modify the designation of a qualified options market maker in the event that the options exchange determines that the qualified options market maker has failed to comply with the terms of the exemption and the exchange believes that such action is warranted in light of the substantial, willful, or continuing nature of the violation. Thus, an options market maker would become a "qualified options market maker" for certain classes of stock options only if it has received an appointment as such from a qualified options exchange. All of the options exchanges have submitted proposals to the SEC that would make them eligible to become qualified options exchanges and it is the NASD's understanding that the SEC will approve these proposals before the short-sale rule goes into effect.

Warrant Market-Maker Exemption
The rule contains an exemption for warrant market makers similar to the one available for options market makers. To be eligible for the exemption, the warrant market maker must be registered as a market maker in the warrant and the short sale must be an "exempt hedge transaction" that results in a fully hedged position. An "exempt hedge transaction" is a short sale in a Nasdaq National Market security that was effected to hedge, and in fact serves to hedge, an existing offsetting warrant position created in a transaction that was contemporaneous with the short sale.

Any short sale by a warrant market maker unrelated to normal warrant market-making activity, such as index arbitrage or risk arbitrage that in either case is independent of a warrant market maker's market-making functions, however, will not be considered an "exempt hedge transaction."

Rule Interpretations

There are three Interpretations by the Board of Governors of the NASD dealing with the short-sale rule. Interpretation A clarifies some of the factors that will be taken into consideration when reviewing market- making activity that may not be deemed to be bona fide market- making activity and, therefore, not exempt from the rule's application. Specifically, Interpretation A provides that bona fide market-making activity does not include activity unrelated to market-making functions, such as index arbitrage and risk arbitrage that is independent from a member's market-making functions. Similarly, Interpretation A states that bona fide market making would exclude activity that is related to speculative selling strategies of the member or investment decisions of the firm and is disproportionate to the usual market- making patterns or practices of the member in that security. In addition, Interpretation A provides guidance for what constitutes bona fide market making in the context of a merger or acquisition (this issue also is examined in the "Questions and Answers" section below).

Interpretation B defines a "legal" short sale on a down bid as one that is executed at a price at least 1/16th above the current inside bid. The last-sale report for such a trade would, therefore, be above the inside bid by at least 1/16th.

Interpretation C clarifies some of the circumstances under which a mem-

is meant to include transactions occurring simultaneously as well as transactions occurring within the same brief period of time.

ber would violate the rule. Specifically, Interpretation C contains the following non-exhaustive list of activities that would be considered manipulative acts and violations of the rule:

• In instances where the current best bid is below the preceding best bid, a market maker alone at the inside best bid may not lower its bid and then raise it to create an "up bid" for the purpose of facilitating a short sale.

• A market maker with a long stock position may not raise its bid above the inside bid and then lower it to create a "down bid" for the purpose of precluding market participants from selling short.

• A market maker may not arrange with a member or a customer to raise its bid in Nasdaq to effect a short sale for the other party while being protected against any loss on the trade or on any other executions effected at its new bid price.

• A market maker may not arrange with a member or a customer to use its exemption from the rule to sell short at the bid at successively lower prices, accumulate a short position, and then offset those sales through a transaction at a prearranged price, to avoid compliance with the rule, and with the understanding that the member or customer would guarantee the market maker against losses on the trades.

Amendments To ACT Rules

In addition to approving Nasdaq's short-sale rule, the SEC also approved a requirement that members append a designator to their ACT reports indicating whether certain sales are short sales or short sales exempt from the rule. Specifically, a "sell short" designator is required for all proprietary short sales by members who are not qualified market makers and short sales by customers, even when a qualified market maker facilitates a short sale for a customer (i.e., buys as principal from a customer selling short). In addition, if a short sale by a customer or a non-qualified market maker is exempt from the rule, a "sell short exempt" designator must be appended to the ACT report.

Questions And Answers

Scope and Effective Date
Question #1: To what stocks will the short-sale rule apply?

Answer: Nasdaq's short-sale rule applies only to Nasdaq National Market securities.

Question #2: Does Nasdaq's short-sale rule apply to preferred securities or convertible preferred securities traded on the Nasdaq National Market?

Answer: Yes. Nasdaq's short-sale rule applies to all securities traded on the Nasdaq National Market, unless otherwise provided by the NASD.

Question #3: When will the short-sale rule become effective?

Answer: The short-sale rule will become effective September 6, 1994, for an 18-month pilot period. On September 6, 1995, one year after the rule is in effect, the Primary Nasdaq market maker standards will take effect.

Operation Of The Rule
Question #4: When the inside bid is lower than the preceding bid, are customers and members precluded from selling short?

Answer: Absent an exemption from the rule, customers and members may not sell short at or below the bid when the inside bid is lower than the previous inside bid. However, short sales may occur if they are priced at least 1/16th above the bid.

Question #5: Does the daily calculation of up and down bids start with the opening bid (i.e., can you always sell short on the opening bid)?

Answer: 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.

Question #6: How will Nasdaq trading services such as SelectNet℠ and the Advanced Computerized Execution System (ACES®) operate under the short-sale rule?

Answer: Members will have to mark SelectNet orders as short sales when entering them. The short-sale information will be retained by the NASD for surveillance purposes and will not be revealed to market makers receiving the orders. SelectNet will not inhibit the execution of short sales. Rather, the order-entry firm has to monitor the bid condition and assure compliance with the rule. The NASD Market Surveillance Department will monitor questionable short-sale activity in SelectNet and will investigate suspected rule violations. ACES is available for short sales, however, ACES has been programmed so that it will not automatically execute a short sale on a down bid. In addition, order-entry firms are reminded that they are prohibited from entering short sales into the Small Order Execution System (SOES℠).

Question #7: Are members responsible for monitoring their open SelectNet short-sale orders to comply

with the short-sale rule? For example, what if a member is long and then puts a sell order into SelectNet but later in the day the member discovers it is short and the bid is down. In this case, must that order be canceled because an execution would result in a violation of the short-sale rule?

Answer: Yes. Members are required to comply with the short-sale rule at all times. The status of an open order in SelectNet or any other execution system must be monitored to assure compliance with the rule.

Question #8: If a Nasdaq market maker executes a short sale for a qualified options market maker on a down bid and it is subsequently determined that the options market maker was not entitled to the exemption, did the Nasdaq market maker violate the short-sale rule?

Answer: No. Section 48(h)(2)(f) of the Nasdaq short-sale rule provides that a member will not be in violation of the short-sale rule if it executes a short sale for the account of a qualified options market maker that is in violation of the options market maker exemption, provided that the member did not know or have reason to know that the options market maker's short sale violated the exemption.

Question #9: Can a firm "journal" short positions established pursuant to the market-maker exemption from its market-making department to other departments within the firm?

Answer: Nasdaq's short-sale rule does not constrain the ability of firms to "journal" positions between departments within the firm. However, if a firm establishes a short position in reliance on the market-maker exemption just to transfer this position to another department in circumvention of the rule, the NASD would view this as a violation. As noted in Interpretation C to the rule, the NASD believes member attempts to circumvent the rule through indirect actions are antithetical to the purposes of the rule.

Question #10: Does a member's obligation to comply with the NASD's Limit Order Protection Interpretation supersede the member's obligation to comply with Nasdaq's short-sale rule?

Answer: Once a limit order to buy is activated, the member must fill the order, regardless of whether the member is long or short the stock. For example, if a market maker with a short position of 1,500 shares in XYZ fills a market order to sell for 500 shares at the inside bid on a down bid while holding a customer's limit order to buy priced at the bid, it must execute the limit order to buy it by effecting a short sale at the down bid. The NASD would view the execution of the short sale as effectively achieving a cross between the limit order to buy and the market order to sell.

Question #11: How will the NASD treat new Nasdaq National Market securities that come from The Nasdaq SmallCap Market℠ or that transfer from another marketplace? Will all new market makers in these securities be automatically qualified without the 20-business-day test?

Answer: Yes. All market makers in a new Nasdaq National Market issue will be qualified if they register and begin quoting in the security within the first 48 hours. If, however, a market maker registers and begins quoting after this time period, it must wait the 20-business-day period to qualify.

Question #12: If a security migrates to the Nasdaq National Market from the Nasdaq SmallCap Market, the OTC Bulletin Board®, or another exchange, will an up bid or down bid be calculated for these securities at the opening of trading on Nasdaq?

Answer: Yes. Nasdaq will compare the opening inside bid on Nasdaq with the closing inside bid on the market where the security last traded to determine whether the inside bid at the opening is up or down.

Question #13: In the case of an ADR traded on the Nasdaq National Market, if the price of the underlying foreign security were to go down overnight, causing the inside bid on Nasdaq to decline, can any person sell short at the lower inside bid? In other words, is there an "international equalizing exemption" comparable to the one in place for exchange-listed ADRs?

Answer: Yes. Consistent with a no-action position issued by the staff of the SEC for applying SEC Rule 10a-1 to exchange-listed ADRs, the NASD has interpreted its short-sale rule to provide that any person can sell a foreign security, or a depositary share or a depositary receipt relating to such a security, on a down bid at the opening, provided that the inside bid is equal to or above the last reported sale price (adjusted for current exchange rates and ADR multiples) of that security in the principal foreign market for the security.

Question #14: Will a cash dividend and any resulting reduction in bid price be considered a down bid for purposes of the short-sale rule?

Answer: No. A cash dividend adjustment will not create a down bid for purposes of the short-sale rule. In these situations the NASD will manually adjust the bid indicator.

Determining Net Long Or Short Positions

Question #15: How will a firm know when it is "long" or "short" in a stock?

Answer: SEC rules (now part of

Nasdaq's short-sale rule) require members to aggregate and net all firm positions in each stock to determine if the member is long or short in each issue.

Question #16: Can NASD members rely on their established procedures for determining intraday whether they have a net long or short position in an exchange-listed security to also determine intraday whether they have a net long or short position in a Nasdaq National Market security?

Answer: Yes.

Question #17: Does a firm violate the rule if it effects a sale for its own account under the mistaken but good faith belief that it was long in the security and subsequently determines that the sale was in fact a short sale?

Answer: If a firm adheres to its established procedures for determining intraday whether it has a net long or short position in a particular security, and, as a result, believes in good faith that it is long the stock when it effects the sale, the NASD would not consider the sale a violation of the short-sale rule if it were later determined that the firm's good faith belief was wrong and the firm was short when it sold the stock. Nevertheless, a pattern of such transactions would militate against the presumption that the firm was acting in good faith when it effected the sale and may subject the firm to disciplinary action for violation of the short-sale rule.

Question #18: How should firms calculate their overall long or short positions when there is a qualified market maker in-house?

Answer: In each Nasdaq National Market security, all firm positions must be aggregated to determine whether the firm is long or short, regardless of the presence of a qualified market maker. For example, if a qualified market maker is short 5,000 shares and another firm position is long 1,000 shares, the firm would be considered short 4,000 shares, regardless of the fact that the qualified market maker may sell short out of its market-making position.

Question #19: If a firm owns shares of an ADR listed on Nasdaq as well as shares of the underlying security registered in another marketplace, may the firm aggregate its underlying shares with the ADRs to calculate a net position?

Answer: Yes, aggregation of ADRs and underlying securities on a share-for-share basis is appropriate.

Question #20: In a merger or acquisition situation, may the broker/dealer aggregate or net its positions in both the target company and the acquirer to determine its overall long or short position?

Answer: No. This type of aggregation is not permitted.

Question #21: If a member is long 500 shares and wants to sell 600 shares, the firm may treat this either as a long sale for 500 and a short sale for 100 (two reports), or it may mark the entire order as a short sale. But if a member is long 500 shares and sells 535, what do you do?

Answer: The short-sale rule does not apply to odd lots, therefore the order may be marked and executed as a long sale.

Qualified Market-Maker Exemption
Question #22: When does the 20-business-day "time in grade" qualification standard for market makers come into effect?

Answer: On the first day of the short-sale rule's implementation, all market makers will be "grandfathered" and considered qualified market makers. Thereafter, market makers that register and begin quoting a Nasdaq National Market issue must wait 20 business days before becoming a qualified market maker. Each market maker is then qualified on the 21st day.

Question #23: With IPOs, the rule affords market makers that pick up the security an exemption if they stay in it for 20 days. In what time period must they register and begin quoting in the IPO?

Answer: Same day, on-line registration is possible using Nasdaq Market Operations personnel. However, to be qualified, all market makers must register and begin quoting in the IPO before 9:30 a.m., Eastern Time, the business day after the offering.

Question #24: If a firm is a qualified market maker in a security that is the subject of an announced merger or acquisition, may the firm retain its qualified status if the market-making activity passes to the risk-arbitrage trading desk?

Answer: Yes. The firm may retain its status provided that the risk-arbitrage trader complies with the qualification standards. If the firm subsequently engages in speculative selling activity disproportionate to the usual market-making patterns or practices of the member in that security, then those transactions are not covered by the exemption. These conditions are covered in Interpretation A to the rule.

Question #25: If a firm engages in block positioning in a stock in which it is not a qualified market maker, can the firm avail itself of the market-maker exemption when effecting block transactions in that security?

Answer: No. The market-maker exemption is only available to qualified market makers.

Question #26: When Nasdaq is available for the permanent "primary" market-maker qualification calculations (time at the inside, dealer spread in relation to average spread, quote changes in relation to transactions, and proportionate volume), will firms be able to see the actual numbers on their performance in each category in each stock?

Answer: Yes. The calculations will be available to the market makers through the Nasdaq Workstation® terminals.

Question #27: Will Nasdaq Workstations indicate whether a particular market maker is a qualified market maker and, therefore, entitled to an exemption?

Answer: For the first year that the rule is in effect, there will be no qualified market-maker indicator. During the first year, absent an IPO, secondary offering, or merger or acquisition situation, market makers will have to know whether they have been registered in and quoting a stock for more than 20 business-days to determine whether they are eligible for an exemption from the rule. After September 6, 1995, there will be a "P" indicator next to every Primary Nasdaq market maker (i.e., qualified Nasdaq market maker). In addition, market makers will be able to review their status as Primary Nasdaq market makers through Nasdaq.

Identifying Short Sales

Question #28: Will members have to indicate on their ACT reports whether a sale is short?

Answer: Members must append a designator to their ACT reports indicating whether certain sales are short sales or short sales exempt from the rule. Specifically, a "sell short" designator is required for all proprietary short sales by members who are not qualified market makers and short sales by customers, even when a qualified market maker facilitates a short sale for a customer (i.e., buys as principal from a customer selling short). In addition, if a short sale by a customer or a non-qualified market maker is exempt from the rule, a "sell short exempt" designator must be appended to the ACT report. Qualified market makers must indicate short sales as "sell" transactions on their ACT reports. If a report of a sale transaction is transmitted to the ACT Service desk for input into ACT, the report must indicate if the sale is long or short. The NASD will not disseminate this information to the public. However, the NASD will continue to disseminate aggregated monthly short-interest data on Nasdaq securities.

Question #29: If an order-entry firm calls a market maker to execute a short-sale order from a customer, does the order-entry firm have to identify the order as a short sale?

Answer: Both the order-entry firm and the market maker must comply with the short-sale rule. In this instance, the order-entry firm should inform the market maker that the sale is short. If, however, the market maker does not know or has no reason to know that the sale is a short sale, it would not violate the short-sale rule if it were to execute the order at the inside bid on a down bid. The exception to this policy is that market-making firms operating automated systems must have incoming orders marked long or short by the order-entry firm so that the market maker does not violate the short-sale rule by executing a short sale on a down bid. In addition, order-entry firms and market makers that operate automated execution systems must mark their ACT reports using the new short-sale indicator. Members also should remind correspondent brokers of their obligations to mark order tickets short so that the executing member will not violate the short-sale rule.

Question #30: If a firm has entered into a Qualified Service Representative (QSR) arrangement with another firm, must the firm functioning as the QSR indicate if sales by the order-entry firm are short or short-sale exempt?

Answer: Yes.

Question #31: If a non-market maker effects a short-sale transaction with a market maker, is the market maker (who is obligated to report the trade under NASD rules) required to indicate in its ACT report whether the contra-side was a short sale?

Answer: No. However, the member selling short must submit an ACT report indicating that the sale was a short sale. Accordingly, members effecting short sales with market makers will be unable to use the ACT "browse/accept" feature to compare trades in ACT for clearance and settlement purposes.

Question #32: If member firm A sends a short-sale order to member firm B (not a market maker in the stock) and B sends the order to member firm C (a market maker in the stock) to execute the order, which member is responsible for complying with the rule?

Answer: All members must comply with the rule, but in this case the compliance obligation is linked to the amount of information known. For example, if firm A is aware the order is a short sale but does not inform firm B, and the order is executed on a down bid, firm A violates the rule. If firm A knows that the order is a short sale and notifies firm B, then it is firm B's obligation to either relay this information to the executing market maker (firm C) or take responsibility itself for complying with the short-sale rule.

Risk Arbitrage Questions

Interpretation A to the rule clarifies that certain types of trading activity, such as index arbitrage or index arbitrage that is independent from a member's market-making functions, will not be considered bona fide market-making activity. However, Interpretation A does provide that short sales of a security of a company involved in a merger or acquisition will be deemed bona fide market-making activity if made to hedge the purchase or prospective purchase (based on communicated indications of interest) of another security of a company involved in the merger or acquisition, which purchase was made, or is to be made, in the course of bona fide market-making activity. In addition, Interpretation A also provides that the purchase of a security of a company involved in a merger or acquisition made to hedge a short sale of another security involved in the merger or acquisition, which sale was made in the course of bona fide market-making activity, will not cause the sale to be deemed unrelated to normal market-making activity. Interpretation A also provides that short sales made to hedge any such purchases or prospective purchases must be reasonably consistent with the exchange ratio (or exchange-ratio formula) specified by the terms of the merger or acquisition.

The following questions provide more specificity to the principles contained in Interpretation A for risk-arbitrage activity. In each question, a merger or acquisition involving an exchange of stock has been announced wherein stock A is seeking to acquire stock T (the M&A transaction). RMM is a "Risk Arbitrage Market Maker"—a broker/dealer that is a qualified market maker and is also engaged in risk arbitrage with regard to the M&A transaction. Consequently, in each question, RMM has a short position in stock A and a corresponding long position in stock T. Each question assumes that the short sale described therein is executed at or below the inside bid when the inside bid, displayed in Nasdaq, is below the preceding inside bid (i.e., a minus bid). Each question further assumes that all other conditions of the proposed short-sale rule have been met.

Question #33: RMM, a qualified market maker in both stocks A and T, receives a sell order at the bid for stock T . RMM, acting as a market maker in stock T, purchases the position from the customer at the bid and sells short stock A to hedge its position in stock T. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: Yes. RMM initiated the trading activity with a purchase on the bid. The original purchase was a bona fide market-making transaction that added liquidity to the market in stock T. In addition, if RMM indicated its interest in purchasing stock T in AUTEX or placed an order to buy in Instinet or SelectNet priced below the inside offer, the NASD also would deem the short sale in stock A to hedge the purchase of stock T to be bona fide market-making activity. In sum, as long as RMM is purchasing stock T on the bid or purchasing stock T in response to its indication of interest to buy stock T at a price better than the inside bid but below the inside offer, short sales in stock A to hedge such purchases are within the qualified market-maker exemption.

Question #34: RMM is registered as a qualified market maker in both stocks A and T. The offer price of stock T is attractive versus the bid price of stock A. RMM buys stock T at the offer and sells short stock A at the bid. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: No. The qualified market-maker exemption would not be available to RMM. RMM's interest in selling stock A is driven solely by its own interest in the M&A transaction and the attractive pricing, not as a response to customer interest in the security or in the interest of providing market liquidity in stock A or T. Therefore, the market-maker exemption would not be available. In sum, if RMM purchases stock T at the offer or purchases stock T below the offer by entering an order to buy that is not publicly advertised (for example, a preferenced order in SelectNet) and then immediately sells stock A short, the short sale of stock A does not fall within the qualified market-maker exemption.

Question #35: RMM is registered as a market maker in both stocks A and T. ABC, a large, well known investment adviser, has placed orders with RMM to sell stock A for three consecutive days, which RMM has executed as principal. On day four, in reasonable anticipation of continued sell interest from ABC, RMM sells short stock A. ABC does not place an order that day. Immediately after selling stock A short, RMM acquires an appropriate amount of stock T to hedge the short sale in stock A by improving the bid price for stock T or initially entering a publicly advertised order to buy stock T (for example, through an unpreferenced order in SelectNet or the use of AUTEX or Instinet). RMM has no other transactions in stock A or T that day. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: Yes. RMM's immediate purchase of stock T at a price below the offer due to RMM's improving its bid for stock T or initially entering a publicly advertised order to buy stock T at a price above the inside bid in stock T provides liquidity to the market in stock T and affords sellers of stock T a superior sale price. Therefore, the qualified

market-maker exemption would be available. In sum, if RMM sells stock short at the bid and immediately thereafter purchases stock T at a price below the offer by improving its bid or initially publicly advertising an order to buy stock T at a price above the inside bid for stock T, the short sale in stock A will be deemed bona fide market-making activity.

Question #36: Immediately after selling stock A short, RMM purchases stock T in response to a market order to sell stock T. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: Yes. RMM's purchase of stock T during the normal course of market-making activity would never cause a short sale in stock A to not be deemed bona fide market-making activity.

Question #37: Immediately after selling stock A short, RMM actively seeks out by telephone or by a preferenced order through an electronic or other automated system another market maker or customer and purchases an appropriate amount of stock T to hedge the short sale in stock A. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: No. RMM's efforts to actively seek out by telephone or by a preferenced order through an electronic or other automated system another market maker or customer to sell stock T to RMM immediately after RMM executes the short sale of stock A indicates that RMM's interest in selling stock A was driven solely by its own interest in the M&A transaction, and not as a response to customer interest in the security or in the interest of providing market liquidity in stock A or T. Therefore, the qualified market-maker exemption would not be available.

Question #38: RMM is registered as a qualified Nasdaq market maker in both stocks A and T. Market activity in stocks A and T suggests imminent selling pressure in both. In response to this anticipated selling pressure, RMM sells short stock A. After a reasonable period of ordinary market-making activity in stock T (or just before the close), RMM purchases an appropriate amount of stock T at the offer. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: Yes. If RMM sells short stock A on the bid in anticipation of selling pressure in stock A that does not materialize, the short sale of stock A would be deemed to be bona fide market-making activity if RMM hedged the short sale in stock A by purchasing stock T at the offer after a reasonable period of ordinary market making. In sum, if after selling stock A short RMM purchases stock T at the offer after a reasonable period of ordinary market-making activity, such subsequent purchases of stock T to hedge the short sale in stock A will not cause the short sale in stock A to not be deemed bona fide market-making activity. In addition, if RMM sells stock A short at the bid and immediately thereafter (or after a reasonable period of ordinary market making) purchases stock T at a price below the offer by improving its bid or initally publicly advertising an order to buy stock T at a price above the inside bid for stock T, the short sale in stock A will be deemed bona fide market-making activity.

Question #39: Stock T is exchange-listed while stock A is on Nasdaq. RMM is registered as a qualified market maker in stock A and generally acts as a block positioner in listed stocks such as stock T. In response to customer selling interest, RMM purchases stock T on the bid or in between the bid and ask. To hedge this purchase, RMM sells short stock A. Does the short sale of stock A fall within the qualified market-maker exemption?

Answer: Yes. The principles expressed in the answers to questions 33-38 are equally applicable to situations where one of the stocks involved in a M&A transaction is exchange listed. Accordingly, because RMM is adding liquidity to the market for stock T as a block positioner, the related short sale of stock A would be consistent with bona fide market-making activity.

Question #40: If a qualified options market maker makes a market in a security (stock T) that becomes the target of a merger or acquisition by another company (stock A), do short sales in stock A by the options market maker to hedge options positions in stock T qualify as "exempt hedge transactions"?

Answer: Yes. Such short sales are exempt assuming the short sale in stock A hedges an existing or prospective position (based on communicated, specified indications of interest) in options on stock T. It will be primarily up to the qualified options exchange to determine if such short sales are in fact "exempt hedge transactions." In addition, with respect only to merger or acquisition situations, the NASD has taken the position that short sales in the "other" security involved in the merger or acquisition (i.e., the security for which the options market maker does not make an options market, if there are options on that security at all) need not qualify for good faith margin treatment under Regulation T under the Securities Exchange Act of 1934.

Questions regarding this Notice should be directed to James M. Cangiano, Senior Vice President, Market Surveillance, at (301) 590-6424; Glen Shipway, Senior Vice President, Nasdaq Market Operations, at (203) 385-6250; or Thomas R. Gira, Assistant General Counsel, at (202) 728-8957.

Text Of Section 48 Of The NASD Rules Of Fair Practice

(**Note:** New text is underlined.)

Nasdaq Short-Sale Rule: Effective September 6, 1994

(a) 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 when the current best (inside) bid as displayed by the Nasdaq system is below the preceding best (inside) bid in the security.

(b) In determining the price at which a short sale may be effected after a security goes ex-dividend, ex-right, or ex-any other distribution, all quotation prices prior to the "ex" date may be reduced by the value of such distribution.

(c) The provisions of subsection (a) shall not apply to:

(1) Sales by a qualified market maker registered in the security in the Nasdaq system in connection with bona fide market-making activity. For purposes of this subsection, transactions unrelated to normal market-making activity, such as index arbitrage and risk arbitrage that is independent from a member's market-making functions, will not be considered bona fide market-making activity.

(2) Any sale by any person, for an account in which he has an interest, if such person owns the security sold and intends to deliver such security as soon as possible without undue inconvenience or expense;

(3) Sales by a member, for an account in which the member has no interest, pursuant to an order to sell which is marked "long" in which the member does not know, or have reason to know, that the beneficial owners of the account have, or would as a result of such sales have, a short position in the security.

(4) Sales by a member to offset odd-lot orders of customers.

(5) Sales by a member to liquidate a long position which is less than a round lot, provided that such sale does not change the position of the member by more than one unit of trading.

(6) Sales by a person of a security for a special arbitrage account if the person then owns another security by virtue of which the person is, or presently will be, entitled to acquire an equivalent number of securities of the same class of securities sold; provided such a sale, or the purchase which such sale offsets, is effected for the bona fide purpose of profiting from a current difference between the price of the security sold and the security owned and that such right of acquisition was originally attached to or represented by another security or was issued to all the holders of any such class of securities of the issuer.

(7) Sales by a person of a security effected for a special international arbitrage account for the bona fide purpose of profiting from a current difference between the price of such security on a securities market not within or subject to the jurisdiction of the United States and on such a securities market subject to the jurisdiction of the United States; provided the person at the time of such sale knows or, by virtue of information currently received, has reasonable grounds to believe that an offer enabling the person to cover such sale is then available to the person in such foreign securities market and intends to accept such offer immediately.

(8) Sales by an underwriter, or any member of a syndicate or group participating in the distribution of a security, in connection with an over-allotment of securities, or any layoff sale by such a person in connection with a distribution of securities through rights pursuant to SEC Rule 10b-8 or a standby underwriting commitment.

(d) No member shall effect a short sale for the account of a customer or for its own account indirectly or through the offices of a third party to avoid the application of this section.

(e) No member shall knowingly, or with reason to know, effect sales for the account of a customer or for its own account to avoid the application of this section.

(f) A member that is not currently registered as a Nasdaq market maker in a security and that has acquired a security while acting in the capacity of a block positioner shall be deemed to own such security for the purposes of this rule notwithstanding that such member may not have a net long position in such security if and to the extent that such member's short position in such security is the subject of one or more offsetting positions created in the course of bona fide arbitrage, risk arbitrage, or bona fide hedge activities.

(g) For purposes of this section, a depositary receipt of a security shall be deemed to be the same security as the security represented by such receipt.

(h)(1) A member shall be permitted, consistent with its quotation obligations, to execute a short sale for the account of an options market maker that would otherwise be in contravention of this section, if:

(a) the options market maker is registered with a qualified options exchange as a qualified options market maker in a stock options class on a Nasdaq National Market security or

an options class on a qualified stock index; and

(b) the short sale is an exempt hedge transaction.

(2) For purposes of this subsection:

(a)(i) An "exempt hedge transaction," in the context of qualified options market makers in stock options classes, shall mean a short sale in a Nasdaq National Market security that was effected to hedge, and in fact serves to hedge, an existing offsetting options position or an offsetting options position that was created in a transaction(s) contemporaneous with the short sale,[1] provided that when establishing the short position the options market maker is eligible to receive(s) good faith margin pursuant to Section 220.12 of Regulation T under the Securities Exchange Act of 1934 for that transaction.

(ii) An "exempt hedge transaction," in the context of qualified options market makers in stock index options classes, shall mean a short sale in a Nasdaq National Market security that was effected to hedge, and in fact serves to hedge, an existing offsetting stock index options position or an offsetting stock index options position that was created in a transaction(s) contemporaneous with the short sale, provided that: (a) the security sold short is a component security of the index underlying such offsetting index options position; (b) the index underlying such offsetting index options position is a "qualified stock index"; and (c) the dollar value of all exempt short sales effected to hedge the offsetting stock index options position does not exceed the aggregate current index value of the offsetting options position.

(iii) Notwithstanding any other provision of this subsection, any transaction unrelated to normal options market making activity, such as index arbitrage or risk arbitrage that in either case is independent of an options market maker's market making functions, will not be considered an "exempt hedge transaction."

(b) A "qualified options market maker" shall mean an options market maker who has received an appointment as a "qualified options market maker" for certain classes of stock options on Nasdaq National Market securities and/or index options on qualified stock indexes pursuant to the rules of a qualified options exchange.

(c) A "qualified options exchange" shall mean a national securities exchange that has approved rules and procedures providing for:

(i) designating market makers as qualified options market makers, which standards shall be designed to identify options market makers who regularly engage in market making activities in the particular options class(es);

(ii) the surveillance of its market maker's utilization of the exemption set forth in Section 48(h)(1) to assure that short sales effected by qualified options market makers are exempt hedge transactions and that other non-qualified market makers are not utilizing the exemption; and

(iii) authorization of the NASD to withdraw, suspend, or modify the designation of a qualified options market maker but only if a qualified options exchange has determined that the qualified options market maker has failed to comply with the terms of the exemption, and that such a withdrawal, suspension, or modification of the market maker's exemption is warranted in light of the substantial, willful, or continuing nature of the violation.

(d) A "qualified stock index" shall mean any stock index that includes one or more Nasdaq National Market securities, provided that more than 10 percent of the weight of the index is accounted for by Nasdaq National Market securities and provided further that the qualification of an index as a qualified stock index shall be reviewed as of the end of each calendar quarter, and the index shall cease to qualify if the value of the index represented by one or more Nasdaq National Market securities is less than 8 percent at the end of any subsequent calendar quarter.

(e) "Aggregate current index value" shall mean the current index value times the index multiplier.

(f) A member will not be in violation of Section 48(a) above if the member executes a short sale for the account of an options market maker that is in contravention of this subsection (h), provided that the member did not know or have reason to know that the options market maker's short sale was in contravention of this subsection (h).

(i)(1) A member shall be permitted, consistent with its quotation obligations, to execute a short sale for the account of a warrant market maker that would otherwise be in contravention of this section, if:

(a) the warrant market maker is a registered Nasdaq market maker for the warrant; and

(b) the short sale is an exempt hedge transaction that results in a fully hedged position.

(2) For purposes of this subsection, an "exempt hedge transaction" shall mean a short sale in a Nasdaq National Market security that was effected to hedge, and in fact serves

[1] The phrase contemporaneously established includes transactions occurring simultaneously as well as transactions occurring within the same brief period of time.

to hedge, an existing offsetting warrant position or an offsetting warrant position that was created in a transaction(s) contemporaneous with the short sale.[2] Notwithstanding any other provision of this subsection, any transaction unrelated to normal warrant market making activity, such as index arbitrage or risk arbitrage that in either case is independent of a warrant market maker's market making functions, will not be considered an "exempt hedge transaction."

(3) The NASD may withdraw, suspend, or modify the exemption for a warrant market maker upon determination that the market maker has failed to comply with the terms of the exemption, and that such a withdrawal, suspension, or modification of the market maker's exemption is warranted in light of the substantial, willful, or continuing nature of the violation.

(4) A member will not be in violation of Section 48(a) above if the member executes a short sale for the account of a warrant market maker that is in contravention of this subsection (i), provided that the member did not know or have reason to know that the warrant market maker's short sale was in contravention of this subsection (i).

(j) Upon application or on its own motion, the Association may exempt either unconditionally, or on specified terms and conditions, any transaction or class of transactions from the provisions of this section.

(k) From time to time, the Securities and Exchange Commission may amend Rule 10a-1, Rule 3b-3, or Rule 3b-8 under the Securities Exchange Act of 1934. As a result, the Board of Governors may alter, amend, modify, or supplement this section in accordance with amendments to Rule 10a-1, Rule 3b-3, or Rule 3b-8, or as otherwise deemed appropriate or necessary for Nasdaq National Market securities.

(l) Definitions:

(1) The term "short sale" shall have the same meaning as contained in SEC Rule 3b-3, adopted pursuant to the Securities Exchange Act of 1934, reprinted as follows: The term "short sale" means any 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. A person shall be deemed to own a security if: (1) he or his agent has title to it; or (2) he has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it; or (3) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) he has an option to purchase or acquire it and has exercised such option; or (5) he has rights or warrants to subscribe to it and has exercised such rights or warrants; provided, however, that a person shall be deemed to own securities only to the extent that he has a net long position in such securities.

(2) The term "block positioner" shall have the same meaning as contained in SEC Rule 3b-8 for "Qualified Block Positioner" adopted pursuant to the Securities Exchange Act of 1934, reprinted as follows: (c) The term "Qualified Block Positioner" means a dealer who: (1) is a broker or dealer registered pursuant to Section 15 of the Act, (2) is subject to and in compliance with Rule 15c3-1, (3) has and maintains minimum net capital, as defined in Rule 15c3-1, of $1,000,000 and (4) except when such activity is unlawful, meets all of the following conditions: (i) he engages in the activity of purchasing long or selling short, from time to time, from or to a customer (other than a partner or a joint venture or other entity in which a partner, the dealer, or a person associated with such a dealer, as defined in Section 3(a)(18) of the Act, participates) a block of stock with a current market value of $200,000 or more in a single transaction, or in several transactions at approximately the same time from a single source to facilitate a sale or purchase by such customer, (ii) he has determined in the exercise of reasonable diligence that the block could not be sold to or purchased from others on equivalent or better terms, and (iii) he sells the shares comprising the block as rapidly as possible commensurate with the circumstances.

(3) The term "qualified market maker," for a period of one year after the effective date of this section, shall mean a registered Nasdaq market maker that has maintained, without interruption, quotations in the subject security for the preceding 20 business days. Notwithstanding the 20-day period specified in this subsection, after an offering in a stock has been publicly announced, a registration statement has been filed, or a merger or acquisition involving two issues has been announced, no market maker may register in the stock as a qualified market maker unless it meets the requirements set forth below:

(i) For secondary offerings, the offering has become effective and the market maker has been registered in and maintained quotations without interruption in the subject security for 40 calendar days;

(ii) For initial public offerings, the market maker may register in the offering and immediately become a qualified market maker; provided however, that if the market maker withdraws on an unexcused basis from the security within the first 20

[2] The phrase contemporaneously established includes transactions occurring simultaneously as well as transactions occurring within the same brief period of time.

days of the offering, it shall not be designated as a qualified market maker on any subsequent initial public offerings for the next 10 business days;

(iii) After a merger or acquisition involving an exchange of stock has been publicly announced and not yet consummated or terminated, a market maker may immediately register in either or both of the two affected securities as a qualified market maker pursuant to the same-day registration procedures in Part VI, Schedule D to the By-Laws; provided, however, that if the market maker withdraws on an unexcused basis from any stock in which it has registered pursuant to this subsection within 20 days of so registering, it shall not be designated as a qualified market maker pursuant to this subsection for any subsequent merger or acquisition announced within three months subsequent to such unexcused withdrawal.

For purposes of this subsection, a market maker will be deemed to have maintained quotations without interruption if the market maker is registered in the security and has continued publication of quotations in the security through the Nasdaq system on a continuous basis; provided however, that if a market maker is granted an excused withdrawal pursuant to the requirements of Part VI, Schedule D to the By-Laws, the 20-business-day standard will be considered uninterrupted and will be calculated without regard to the period of the excused withdrawal. One year after effectiveness of this section, the term "qualified market maker" shall mean a registered Nasdaq market maker that meets the criteria for a Primary Nasdaq market maker as set forth in Article III, Section 49 of the Rules of Fair Practice.

(m) This section shall be in effect until March 6, 1996.

Interpretation A

In developing a short-sale rule for Nasdaq National Market securities, the Association adopted an exemption to the rule for certain market making activity. This exemption was deemed an essential component of the rule because bona fide market making activity is necessary and appropriate to maintain continuous, liquid markets in Nasdaq National Market securities. Subsection (c)(1) of this section states that short selling prohibitions shall not apply to sales by qualified Nasdaq market makers in connection with bona fide market making activity and specifies that transactions unrelated to normal market making activity, such as index arbitrage and risk arbitrage that is independent from a member's market making functions, will not be considered as bona fide market making. Thus two standards are to be applied: one must be a "qualified" Nasdaq market maker and one must engage in "bona fide" market making activity to take advantage of this exemption. With this Interpretation, the Association wishes to clarify for members some of the factors that will be taken into consideration when reviewing market making activity that may not be deemed to be bona fide market making activity and therefore would not be exempted from the rule's application.

First, as the rule indicates, bona fide market making activity does not include activity that is unrelated to market making functions, such as index arbitrage and risk arbitrage that is independent from a member's market making functions. While these types of arbitrage activity appear to be suitable for the firm's overall hedging or risk management concerns, they do not warrant an exemption from the rule. However, short sales of a security of a company involved in a merger or acquisition will be deemed bona fide market-making activity if made to hedge the purchase or prospective purchase (based on communicated indications of interest) of another security of a company involved in the merger or acquisition, which purchase was made, or is to be made, in the course of bona fide market making activity. The purchase of a security of a company involved on a merger or acquisition made to hedge a short sale of another security involved in the merger or acquisition, which sale was made in the course of bona fide market making activity, will not cause the sale to be deemed unrelated to normal market-making activity. Short sales made to hedge any such purchases or prospective purchases must be reasonably consistent with the exchange ratio (or exchange ratio formula) specified by the terms of the merger or acquisition.

Similarly, bona fide market making would exclude activity that is related to speculative selling strategies of the member or investment decisions of the firm and is disproportionate to the usual market making patterns or practices of the member in that security. The NASD does not anticipate that a firm could properly take advantage of its market maker exemption to effectuate such speculative or investment short selling decisions. Disproportionate short selling in a market making account to effectuate such strategies will be viewed by the NASD as inappropriate activity that does not represent bona fide market making and would therefore be in violation of the rule.

Interpretation B

Section 48 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 current best (inside) bid when the current best (inside) bid as displayed by the Nasdaq system 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. The last sale report for such a trade would, therefore, be above the inside bid by at least 1/16th of a point.

Moreover, the Association believes that requiring short sales to be a minimum increment of 1/16th point above the bid ensures that transactions are not effected at prices inconsistent with the underlying purpose of the rule.

Interpretation C

Section 48 prohibits a member from effecting a short sale for the account of a customer or for its own account directly or through the offices of a third party for the purpose of avoiding the application of the short-sale rule. Further, the section prohibits a member from knowingly, or with reason to know, effecting sales for the account of a customer or for its own account for the purpose of avoiding the rule. With this Interpretation, the Association wishes to clarify some of the circumstances under which a member would be deemed to be in violation of this section.

For example, in instances where the current best bid is below the preceding best bid, if a market maker alone at the inside best bid were to lower its bid and then raise it to create an "up bid" for the purpose of facilitating a short sale, the NASD would consider such activity to be a manipulative act and a violation of the NASD's short-sale rule. The NASD also would consider it a manipulative act and a violation of the rule if a market maker with a long stock position were to raise its bid above the inside bid and then lower it to create a "down bid" for the purpose of precluding market participants from selling short. In addition, if a market maker agrees to an arrangement proposed by a member or a customer whereby the market maker raises its bid in the Nasdaq system in order to effect a short sale for the other party and is protected against any loss on the trade or on any other executions effected at its new bid price, the market maker would be deemed to be in violation of this section. Similarly, a market maker would be deemed in violation of the rule if it entered into an arrangement with a member or a customer whereby it used its exemption from the rule to sell short at the bid at successively lower prices, accumulating a short position, and subsequently offsetting those sales through a transaction at a prearranged price, for the purpose of avoiding compliance with this section, and with the understanding that the market maker would be guaranteed by the member or customer against losses on the trades.

The NASD believes that members' activities to circumvent the rule through indirect actions such as executions with other members or through facilitation of customer orders while being protected from loss are antithetical to the purposes of the rule. Accordingly, the Association will consider any such activity as a violation of this section.

Primary Nasdaq Market Maker Standards: Effective September 6, 1995

Section 49 of the NASD Rules of Fair Practice

(a) A member registered as a Nasdaq Market Maker pursuant to Part VI, Schedule D of the NASD By-Laws may be deemed to be a Primary Nasdaq Market Maker in Nasdaq National Market securities if the market maker complies with threshold standards (as established and published by the Association from time to time) in the following qualification criteria:

(1) amount of time a dealer maintains a quotation that represents the best bid or best offer as shown in the Nasdaq system;

(2) relation of individual dealer spread to average dealer spread; and

(3) frequency of dealer quotation updates without a corresponding execution in the security occurring within three minutes before or after a quotation update.[3]

(b) A market maker for a Nasdaq National Market security must satisfy the threshold standards in at least two of the criteria in section (a) in order to be designated a Primary Nasdaq Market Maker in that security; provided, however, that if a market maker satisfies only one of the criteria, it may qualify as a Primary Nasdaq Market Maker if it also accounts for a threshold level of proportionate volume in the security (as established and published by the Association from time to time).[4]

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[3] The threshold standards initially shall be established as:
(a) a market maker must maintain the best bid or best offer as shown in the Nasdaq system no less than 35 percent of the time;
(b) a market maker must maintain a spread no greater than 102 percent of the average dealer spread;
(c) no more than 50 percent of a market maker's quotation updates may occur without being accompanied by a trade execution of at least one unit of trading.
The NASD Board of Governors reserves the authority to rescind or modify one or more of the threshold standards immediately upon a finding that the standard is operating in a manner that is unfair to a class of investors or members, or that continued imposition of the standard results in a substantial adverse impact on the liquidity or market quality of the Nasdaq market.

[4] The threshold proportionate volume stan-

(c) The review period for review of market maker performance in each of the qualification criteria in section (a), section (g)(1)(b), and section (g)(2)(b)(ii) shall be one calendar month.

(d) If, after the review period, a market maker does not satisfy the threshold standards for the criteria in section (a), the Primary Nasdaq Market Maker designation shall be withheld commencing on the next business day following notice of failure to comply with the standards.

(e) Market makers may requalify for designation as a Primary Nasdaq Market Maker by satisfying the threshold standards for the next review period.

(f) A market maker may request reconsideration of the notice to withhold the Primary Nasdaq Market Maker designation.

(1) Grounds for requests for reconsideration shall be limited to:

(a) system failure;

(b) excused market maker withdrawal status; or

(c) where a market maker failed to qualify under the criteria set forth in subsection (a)(3) because of activity in a related derivative or convertible security, or activity in a security subject to derivative pricing mechanisms, such as currency differentials with foreign stocks.

(2) Requests for reconsideration must be sent in writing to Nasdaq Operations within 24 hours of the determination to withhold the Primary Nasdaq Market Maker designation.

(3) Requests for reconsideration will be reviewed by the Market Operations Review Committee, whose decisions are final and binding on the members.

(g) In registration situations:

(1) To register and immediately become a Primary Nasdaq Market Maker in a Nasdaq National Market security, a member must be a Primary Nasdaq Market Maker in 80 percent of the securities in which it has registered. If the market maker is not a Primary Nasdaq Market Maker in 80 percent of its stocks, it may qualify as a Primary Nasdaq Market Maker in that stock if:

(a) the market maker registers in the stock but does not enter quotes for five days; or

(b) the market maker registers in the stock as a regular Nasdaq market maker and satisfies the qualification criteria for the next review period.

(2) Notwithstanding subsection (g)(1) above, after an offering in a stock has been publicly announced or a registration statement has been filed, no market maker may register in the stock as a Primary Nasdaq Market Maker unless it meets the requirements set forth below:

(a) For secondary offerings:

(i) the secondary offering has become effective and the market maker has satisfied the qualification criteria in the time period between registering in the security and the offering becoming effective; or

(ii) the market maker has satisfied the qualification criteria for 40 calendar days.

(b) For initial public offerings:

(i) the market maker may register in the offering and immediately become a Primary Nasdaq Market Maker if it is a Primary Nasdaq Market Maker in 80 percent of the securities in which it has registered; provided however, that if, at the end of the first review period, the Primary Nasdaq Market Maker has withdrawn on an unexcused basis from the security or has not satisfied the qualification criteria, it shall not be afforded a Primary Nasdaq Market Maker designation on any subsequent initial public offerings for the next 10 business days; or

(ii) the market maker registers in the stock as a regular Nasdaq market maker and satisfies the qualification criteria for the next review period.

(3) Notwithstanding subsection (g)(1) or (g)(2) above, after a merger or acquisition has been publicly announced, a Primary Nasdaq Market Maker in one of the two affected securities may immediately register as a Primary Nasdaq Market Maker in the other merger or acquisition security pursuant to the same-day registration procedures in Part VI, Schedule D to the By-Laws.

(h) The Board of Governors may modify the threshold standards set forth in sections (a) and (b) above if it finds that maintenance of such standards would result in an adverse impact on a class of investors or on the Nasdaq marketplace.

(i) The Board of Governors may alter, amend, modify, or supplement this section as deemed appropriate or necessary for Nasdaq National Market securities without recourse to membership for approval as required by Article XII to the By-Laws.

ACT Rules

d) Trade Report Input

1.-3. Unchanged.

4. *Trade information to be input —*

dard initially shall require a market maker to account for volume of at least one and a half times its proportionate share of overall volume in the stock for the review period.

Each ACT report shall contain the following information:

(A)-(E) Unchanged.

(F) A symbol indicating whether the transaction is a buy, sell, sell short, sell short exempt,* or cross;

(G)-(L) Unchanged.

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* The "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 Section 48 of Article III of the Rules of Fair Practice.