

Amex, CBOE, and PSE proposals were each published for comment in the Federal Register on November 21, 1994.⁵ No comments were received on the proposed rule changes. This order approves the Exchanges' proposals, as amended.

II. Description of Proposals

The Commission recently approved proposals submitted by the options exchange concerning a market maker exemption⁶ to the NASD bid test rule⁷ applicable to short sales to NM securities traded through Nasdaq. The purposes of the market maker exemption is to allow options market makers⁸ to hedge their options positions by buying or selling (including selling short) shares of underlying stock or underlying component stocks contained in stock indexes; such short sales are referred to as "exempt hedge transactions."⁹ The Exchange proposals were approved on a temporary basis to remain in effect concurrently with the NASD's bid test rule pilot program.¹⁰

Currently, the NASDA provides an exemption from the short sale bid test for risk arbitragers (and other NASD members) who take positions in the

stocks involved in M&G transactions.¹¹ Consequently, the Exchange desire to amend their respective rules to extend the market maker exemption from the bid test rule to certain short sales of the stock of a company that is involved in a publicly announced M&A with a company whose stock is a designated Nasdaq/NM security.¹²

III. Discussion

The Commission believes that the Exchanges' proposed rule changes are consistent with the requirements of the Act and the rules and regulations thereunder applicable to national securities exchanges. In particular, the Commission believes the Exchanges' proposals are consistent with the requirements of Section 6(b)(5) of the Act¹³ in that they are designed to remove impediments to, and perfect the mechanism of, a free and open market, and to protect investors and the public interest.

The Commission approved the NASD's short sale rule proposal on June 29, 1994,¹⁴ and in so doing stated that the short sale rule, together with the market maker exemption, is a reasonable approach to regulating short sales of Nasdaq/NM securities. The Commission believes that the Exchanges' proposals are consistent with the NASD's bid test rule and address the limitations established by the NASD concerning the applicability of the market maker exemption.

Specifically, the Exchanges' proposals are designed to extend the market maker exemption to the stock of a company that is involved in a publicly announced M&A with a company whose stock is designated Nasdaq/NM security. The Commission believes that when a designated Nasdaq/NM security becomes involved in an M&A, options market makers may need to hedge positions in options overlying such a designated Nasdaq/NM security by buying or selling the securities of the other company involved in the M&A, whether or not the other company's stock has listed overlying options.

Indeed, where there are no options on the other company's stock, buying or selling that company's stock at times may be the only feasible way for a market maker to hedge positions in options on the designated Nasdaq/NM security, given the risk arbitrage relationship that is likely to exist between the two stocks. Therefore, the Commission believes that by allowing market makers to sell short, for hedging purposes, shares of a company that is involved in an M&A with a company whose stock is a designated Nasdaq/NM security, and to designate such sales as bid test exempt, the Exchanges' proposals will enhance the ability of their market makers perform their market making functions, thereby contributing to the liquidity of the market for options, as well as to the liquidity of the market for the stocks of both companies.

The Commission notes that the proposed extension of the market maker exemption from the short sale rule is limited to publicly announced M&As. Moreover, market makers may avail themselves of the M&A extension to the exemption only when the short sales are made to hedge existing or prospective positions in options on a security of another company involved in the M&A, the options positions are or will be in a class of options for which the market maker is registered and are or will be an "exempt hedge transaction" as defined in the Exchanges' rules.¹⁵

IV Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁶ that the Amex, CBOE, and PSE proposed rule changes (SR-Amex-94-42, SR-CBOE-94-27, and SR-PSE-94-23, respectively), as amended, are approved on a temporary basis, to remain in effect so long as their respective rules regarding the market maker exemption¹⁷ to the NASD's bid test rule remain in effect.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority,¹⁸
Margaret H. McFarland,
Deputy Secretary.
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security involved in an M&A to qualify as an exempt hedge transaction pursuant to the current proposal, the M&A must be publicly announced. See letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Francois Nazur, Attorney, Division, Commission ("PSE Amendment No. 1"). The Commission notes that the Amex proposal, as originally proposed requires the M&A to be publicly announced.

⁵ See Securities Exchange Act Release Nos. 34971 (November 14, 1994), 59 FR 60027 (Amex); 34972 (November 14, 1994), 59 FR 60028 (CBOE); and 34970 (November 14, 1994), 59 FR 60029 (PSE).

⁶ Securities Exchange Act Release No. 34632 (September 2, 1994), 59 FR 46999 (approving proposals by the Amex, CBOE, New York Stock Exchange, Inc., PSE, and Philadelphia Stock Exchange, Inc.).

⁷ The NASD bid test rule prohibits broker-dealers from effecting short sales, for themselves or their customers, at or below the "bid" when the current "inside" or best bid is below the previous inside bid. NASD Rules of Fair Practice ("NASD Rules"), Art. III, Section 48. See Securities Exchange Act Release No. 34277 (June 6, 1994), 59 FR 34885 (amending the NASD Rules to add the short sale rule).

⁸ For purposes of this order, a "market Maker" is a Market Maker as referred to in the CBOE and PSE Rules, and a Specialist or Registered Options Trader as referred to in the Amex Rules.

⁹ An "exempt hedge transaction" is a short sale in an NM security effected to hedge, and which in fact serves to hedge, an existing offsetting options positions or an offsetting contemporaneous with the short sale. See Amex Rule 957(d)(2)(b)(ii), CBOE Rule 15.10(c)(2)(iii)(A), and Rule 4.19(c)(2)(B)(9).

¹⁰ See Securities Exchange Act Release No. 34277, *supra* note 6. The Commission approved the NASD's short sale rule on an eighteen month temporary basis, effective September 6, 1994, through March 5, 1996. *Id.*

¹¹ See Securities Exchange Act Release No. 34277, *supra* note 7. The NASD short sale rule states that once an M&A has been two affected securities may immediately register as a qualified market maker in the other M&A security. See NASD Rules, Article III, 48(1)(3)(iii). Consequently, such a market maker may rely on the market maker exemption for short sales of the other M&A security.

¹² Proposed Rule 957(d)(2)(b)(iv); Proposed CBOE Rule 15.10(a)(2)(ii)(D); and Proposed PSE Rule 4.19(c)(2)(B)(iv). A "designated NM security" is an NM security which the market maker has designated as qualifying for the bid test exemption. See *e.g.*, CBOE Rule 15.10(c)(2)(B).

¹³ 15 U.S.C. 78f(b)(5) (1988).

¹⁴ Securities Exchange Act Release No. 34277, *supra* note 7.

¹⁵ See *supra* note 9.

¹⁶ 15 U.S.C. 78s(b)(2) (1982).

¹⁷ Amex Rule 957, CBOE Rule 15.10, and PSE Rule 4.19.

¹⁸ 17 CFR 200.30-3(a)(12) (1993).