

- Any sale by a market maker to offset odd-lot orders of customers;

- 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 securities as soon as possible without undo inconvenience or expense;

- Sales by a member to liquidate a long position which 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 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;

- 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; and

- Short sales by an underwriter or any member of the distribution syndicate in connection with the over-allotment of securities, or any lay-off sale by such a person in connection with a distribution of securities rights pursuant to SEC Rule 10b-18 or a standby underwriting commitment.

The rule also provides that a member not currently registered as a Nasdaq market maker in a security that has acquired the security while acting in the capacity of a block positioner shall be deemed to own such security for the purposes of the 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 subject to one or more offsetting positions created in the course of bona fide arbitrage, risk

arbitrage, or bona fide hedge activities.⁷ The rule also contains certain limited exemptions for options market makers and warrant market makers.

As with the short-sale rule for NNM securities, which the Commission has approved on a pilot basis, the NASD believes imposing a short-sale rule on SCM securities will promote the maintenance of fair and orderly markets and the protection of investors. Specifically, by helping to prevent speculative short selling in SCM securities from rapidly accelerating a decline in the price of a security and a form of manipulation known as "bear raiding" or "piling on,"⁸ the NASD believes its proposal will enhance the market for SCM securities. The NASD also is concerned that in instances of extreme intra-day volatility in SCM securities that the ability of existing shareholders to sell their stock may be inhibited because professional short sellers are in the market before them, exacerbating downward pressure on stocks and reducing overall liquidity in the marketplace. The NASD believes that expanding the scope of its short-sale rule to include SCM securities will help to curb abusive short selling, reducing the exposure of the Nasdaq market to manipulation and excessive intra-day volatility. Without a short-sale rule for SCM securities, the NASD also believes issuers of SCM securities may be disadvantaged in offerings on Nasdaq because the increased potential for short selling may artificially affect the prices at which such offerings are conducted. In this regard, members report that their investment banking departments may recommend exchange listings for SCM securities because of the lack of adequate short sale regulation in the Nasdaq market. Accordingly, the NASD believes that the proposed modification to the NASD's short-sale rule will assure both issuers and investors in SCM securities that they are subject to at least equivalent protection from predatory short selling in the Nasdaq market as they are on an exchange.

In addition, because the short-sale rule applicable to SCM securities will be identical to the short-sale rule applicable to NNM securities, the NASD

⁷ The NASD also has interpreted its short-sale rule to provide exemptions consistent with SEC staff interpretations of SEC Rule 10a-1 dealing with the liquidation of index arbitrage positions and trading in foreign securities (the so-called "international equalizing exemption"). See Securities Exchange Act Release No. 30772 (June 3, 1992), 57 FR 26891 (June 16, 1992).

⁸ "Piling on" occurs all when short sellers exert substantial selling pressure on a stock with the intent to dominate and demoralize the market for that stock, forcing the price to drop precipitously, frequently with a single trading day.

believes its proposal is structured in a manner to best prevent abusive short sales while also preserving the depth and liquidity of the markets for SCM securities. In this connection, the NASD notes that the Nasdaq Stock Market provides an efficient and liquid trading environment through quote competition among competing market makers. Crucial to the maintenance of this competitive market structure is the requirement for market makers to display firm two-sided quotations. Moreover, the very nature of the competitive market maker system requires dealers to take substantial inventory positions. Accordingly, the NASD believes application of a short-sale rule to SCM securities without an exemption for qualified market makers would result in degradation of the accuracy and reliability of quotations.

The NASD also believes qualified market makers in SCM securities must be permitted the flexibility to sell short when necessary so that they will be able to adjust quickly to market movements and control the risks associated with market making, while continuing to provide the maximum possible liquidity. The ability to manage risk with short positions is fundamental to market maker performance. Market makers need the constant ability to effect short sales to "reliquefy" their positions throughout the trading day. If a short-sale rule were to impact adversely their ability to manage risk, dealers may be forced to reduce their market making support for the SCM securities in which they currently make markets.⁹

Finally, the NASD believes that adoption of a short-sale rule for SCM securities will enhance the Nasdaq Stock Market's ability to compete with exchange primary markets for listings of SCM securities. From a competitive standpoint, the primary exchanges regularly use the lack of a short-sale rule for SCM securities as an argument to try to persuade companies to list on their exchange. Adoption of a short-sale rule for SCM securities will further emphasize to shareholders that Nasdaq provides equivalent short-sale protection to the investing public through rules that are fair, equitable, and consistent with the operation of a quality marketplace.

The NASD believes the proposed rule change is consistent with Sections 15A(b) (6) and (9), Section 11A(a)(1)(C)(i), and Section 11A(c)(1)(F)

⁹ Based on data for the month of August 1995, 73 percent of the market making positions in Nasdaq SmallCap securities would have satisfied the PMM standards.