

review the exemptive relief in light of any comments received.

III. Outstanding Issues

In the 1994 Extension Order, the Commission noted several areas of unresolved issues concerning the Plan.⁷ These issues include, among other matters, whether the Commission should continue to limit the number of OTC securities that may be traded on exchanges pursuant to UTP. Currently, exchanges may extend UTP up to a maximum of 100 securities.⁸ To date, the Commission has solicited comment on this and other matters and has not received evidence that expanding the number of securities would have a negative effect on the markets or the protection of investors. Moreover, the Commission recently received a letter from the Chx requesting that the Commission expand the number of eligible securities from 100 to 500.⁹

Accordingly, the Commission solicits comment specifically on whether it is appropriate to permit exchanges to extend UTP to a maximum of 500 OTC securities for an interim period, and whether all NNM securities should be available for extensions of UTP if the Commission determines that permanent approval of the Plan is appropriate. The Commission preliminarily believes that, after consideration of comments

⁷In the 1994 Extension Order, the Commission requested views on numerous issues presented by the pilot program, and requested that the Participants submit reports to the Commission on those issues by September 30, 1994. See *Supra* note 4. The Commission received a report from the Philadelphia Stock Exchange as an attachment to its proposed rule change requesting an extension of the Phlx's pilot procedures for OTC/UTP. See letter from William W. Uchimoto, General Counsel, Phlx, to Elizabeth Prout, Division of Market Regulation, Commission, dated December 21, 1994 (attachment to File No. SR-PHLX-94-70). The other Participants have not complied with the Commission order, and must respond to the Commission request immediately.

⁸Prior to 1985, the Commission generally did not permit exchanges to extend UTP to OTC securities. In 1985, the Commission determined that it would be appropriate to permit exchanges, on a temporary basis and subject to certain limitations, to extend UTP up to a maximum of 25 OTC securities. These limitations included the requirement that the NASD and exchanges seeking to extend UTP to OTC securities enter into a plan for consolidated transaction and quotation dissemination. See Securities Exchange Act Release No. 22412 (September 16, 1985), 50 FR 38640. In 1986, the Midwest Stock Exchange (currently the Chicago Stock Exchange, or "Chx") entered into an interim plan which subsequently was superseded by the Plan currently operating on a pilot basis. In 1990, the Commission expanded the maximum number of eligible securities to 100. See 1990 Approval Order, *supra* note 3.

⁹See letter from George T. Simon, Foley & Lardner, to Katherine England, Assistant Director, Commission, dated January 9, 1995. This letter also concludes that, when the Plan is finally approved, all NNM stocks would be eligible for trading.

received, it may be appropriate to expand the number of eligible securities prior to the Commission's review of other matters associated with the Plan in August 1995.

The Commission also notes other areas for commenters to address: (1) Whether the BBO calculation for the relevant securities should be based on price and time only (as currently is the case) or if the calculation should include size of the quoted bid or offer; and (2) whether there is a need for an intermarket linkage for order routing and execution and an accompanying trade-through rule.

IV. Solicitation of Comment

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed plan amendment that are filed with the Commission, and all written communications relating to the proposed plan amendment between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. All submissions should refer to File No. S7-24-89 and should be submitted by February 9, 1995.

VI. Conclusion

The Commission finds that proposed Amendment No. 2 to the Plan to extend the financial negotiation period for an additional seven months is appropriate and in furtherance of Section 11A of the Act. The Commission also finds that extensions of the exemptive relief requested through August 12, 1995, and described above, also is consistent with the Act and the rules thereunder. Specifically, the Commission believes that these extensions should serve to provide the Participants with more time to conclude their financial negotiations and to evaluate the effects of the pilot program and report their findings to the Commission. This, in turn, should further the objects of the Act in general, and specifically those set forth in Section 12(f) and 11A of the Act and in Rules 11Aa3-1 and 11Aa3-2 thereunder.

It is therefore ordered, pursuant to Sections 12(f) and 11A of the Act and paragraph (c)(2) of Rule 11Aa3-2

thereunder, that Amendment No. 2 to the Joint Transaction Reporting Plan for Nasdaq/National Market securities traded on an exchange on an unlisted or listed basis is hereby approved, and trading pursuant to the Plan is hereby approved on a temporary basis through August 12, 1995.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(29).

Margaret H. McFarland,
Deputy Secretary.

[FR Doc. 95-1230 Filed 1-18-95; 8:45 am]

BILLING CODE 8010-01-M

[Release No. 34-35211; File Nos. SR-Amex-94-12, SR-CBOE-94-27; and SR-PSE-94-23]

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the American Stock Exchange, Inc., the Chicago Board Option Exchange, Inc., and Pacific Stock Exchange, Inc.; Relating to Short Sales of Nasdaq/NM Securities of Companies Involved in a Merger or Acquisition

January 10, 1995.

I. Introduction

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² on October 14, 1994, the American Stock Exchange, Inc. ("Amex"), on August 4, 1994, the Chicago Board Options Exchange, Inc. ("CBOE"), and on August 8, 1994, the Pacific Stock Exchange, Inc. ("PSE"), respectively (each individually referred to herein as an "Exchange" and two or more collectively referred to as "Exchange"), submitted to the Securities and Exchange Commission ("Commission") proposed rule changes relating to extending the market maker exemption from the NASD's short sale rule to Nasdaq National Market ("Nasdaq/NM" or "NM") securities involved in merger and acquisition ("NSA") transactions. On September 29, 1994, the CBOE filed Amendment No. 1 to its proposal,³ and on October 14, 1994, the PSE filed Amendment No. 1 to its proposal.⁴ The

¹ 15 U.S.C. 78s(b)(1) (1988).

² 17 CFR 240.19b-4 (1993).

³In Amendment No. 1, the CBOE adds the requirement that for a short sale in a Nasdaq/NM 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 L. Meyer, Schiff Hardin & Waite, to Francois Mazur, Attorney, Division of Market Regulation ("Division"), Commission, dated September 29, 1994 ("CBOE Amendment No. 1").

⁴In Amendment No. 1, the PSE adds the requirement that for a short sale in a Nasdaq/NM

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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

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.*

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.

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.

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.

[FR Doc. 95-1281 Filed 1-18-95; 8:45 am]

BILLING CODE 8010-01-M1

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).