

at maturity, that the maximum return on the Notes is limited to \$11 and \$16 per unit,<sup>21</sup> that the Notes will not pay interest, and that the Notes will provide full exposure to any downside movement in the Index. Distribution of the circular should help to ensure that only customers with an understanding of the risks attendant to the trading of the Notes and who are able to bear the financial risks associated with transactions in the Notes will trade the Notes. In addition, the Commission notes that Merrill Lynch will deliver a prospectus in connection with the initial purchase of the Notes.

Second, the Commission notes that the final rate of return on the Notes depends, in part, upon the individual credit of the issuer, Merrill Lynch. To some extent this credit risk is minimized by the NASD's listing standards in NASD Rule 4420(f), which provide that only issuers satisfying substantial asset and equity requirements may issue these types of hybrid securities. In addition, the NASD's hybrid listing standards further require that the Notes have at least \$4 million in market value. Financial information regarding Merrill Lynch, in addition to information concerning the issuers of the securities comprising the Index, will be publicly available.<sup>22</sup>

Third, the Notes will be registered under Section 12 of the Act. As noted above, the NASD's and Nasdaq's existing equity trading rules will apply to the Notes, which will be subject to equity margin rules and will trade during the regular equity trading hours of 9:30 a.m. to 4 p.m. NASD Regulation's surveillance procedures for the Notes will be the same as its current surveillance procedures for equity securities, and will include additional monitoring on key pricing dates.

Fourth, the Commission has a systemic concern that a broker-dealer, such as Merrill Lynch, or a subsidiary providing a hedge for the issuer will incur position exposure. However, as the Commission has concluded in previous approval orders for the hybrid instruments issued by broker-dealers,<sup>23</sup>

the Commission believes that this concern is minimal given the size of the Notes issuance in relation to the net worth of Merrill Lynch.

Finally, the Commission believes that the listing and trading of the proposed Notes should not unduly impact the market for the securities underlying the Index or raise manipulative concerns. In approving the product, the Commission recognizes that the Nasdaq-100 Index is a modified capitalization-weighted index of 100 of the largest, non-financial companies listed on The Nasdaq National Market tier of Nasdaq. The Commission notes that the Index is determined, composed, and calculated by Nasdaq. As of November 30, 2002, the adjusted market capitalization of the securities included in the Nasdaq-100 Index ranged in capitalization from a high of \$200.6 billion to a low of \$1.2 billion. In addition, the average daily trading volume for the component stocks for the last eleven months, as of the same date, ranged from a high of 79.9 million shares to a low of 634, 118 shares. Given the large capitalizations, liquid markets, and relative weightings of the Index's component stocks, the Commission continues to believe, as it has concluded previously, that the listing and trading of the Notes that are linked to the Nasdaq-100 Index, should not unduly impact the market for the underlying securities comprising the Nasdaq-100 Index or raise manipulative concerns.<sup>24</sup> As discussed more fully above, the Commission also believes that the weighting and potential quarterly rebalancing of the Nasdaq-100 Index should ensure that no one stock or group of stocks significantly minimize the potential for manipulation of the Index. Moreover, the issuers of the underlying securities comprising the Nasdaq-100 Index, are subject to reporting requirements under the Act, and all of the component stocks are either listed on Nasdaq or the NYSE or be an affiliate of a company listed on Nasdaq or the NYSE. In addition, Nasdaq's surveillance procedures should serve to deter as well as detect any potential manipulation. The Commission also notes that the value of the Nasdaq-100 Index is disseminated every 15 seconds over the Nasdaq Trade Dissemination System.

The Commission finds good cause for approving the proposed rule change, as

amended, prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that the Notes will provide investors with an additional investment choice and that accelerated approval of the proposal will allow investors to begin trading the Notes promptly. In addition, the Commission notes that it has previously approved the listing and trading of similar Notes and other hybrid securities based on the Nasdaq-100.<sup>25</sup> Accordingly, the Commission believes that there is good cause, consistent with Sections 15A(b)(6) and 19(b)(2) of the Act,<sup>26</sup> to approve the proposal, as amended, on an accelerated basis.

## V. Conclusion

*It is therefore ordered*, pursuant to Section 19(b)(2) of the Act,<sup>27</sup> that the proposed rule change (SR-NASD-2002-175), as amended, is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>28</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 02-32317 Filed 12-23-02; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46995; File No. SR-NASD-2002-166]

### Self-Regulatory Organizations; Notice of Filing of a Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Margin Rule Amendments for Security Futures Contracts

December 13, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on November 15, 2002, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. On November 22, 2002, NASD filed an amendment to the proposed rule

<sup>21</sup> The actual Capped Value will be determined at the time of issuance of the Notes.

<sup>22</sup> The companies comprising the Index are reporting companies under the Act.

<sup>23</sup> See, e.g., Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving File No. SR-NASD-2001-73) (approving the listing and trading of notes issued by Morgan Stanley Dean Witter & Co. whose return is based on the performance of the Index); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (order approving File No. SR-Amex-2001-40) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a portfolio of 20 securities selected from the Amex

Institutional Index); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving File No. SR-Amex-96-27) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a weighted portfolio of healthcare/biotechnology industry securities).

<sup>24</sup> See note 8, *supra*.

<sup>25</sup> See *supra* note 16.

<sup>26</sup> 15 U.S.C. 78o-3(b)(6) and 78s(b)(2).

<sup>27</sup> 15 U.S.C. 78s(b)(2).

<sup>28</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend NASD Rule 2520 ("Margin Requirements") to establish margin requirements for security futures contracts. The proposed rule change is being made to make NASD's margin rule consistent with the margin rules already adopted by the SEC, the Commodity Futures Trading Commission ("CFTC"), and other self-regulatory organizations ("SROs") regarding security futures contracts. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

\* \* \* \* \*

#### 2520. Margin Requirements

##### (a) Definitions

For the purposes of this paragraph, the following term shall have the meanings specified below:

(1) The term "basket" shall mean a group of stocks that NASD or any national securities exchange designates as eligible for execution in a single trade through its trading facilities and that consists of stocks whose inclusion and relative representation in the group are determined by the inclusion and relative representation of their current market prices in a widely-disseminated stock index reflecting the stock market as a whole.

(2) The term "current market value" means the total cost or net proceeds of a security on the day it was purchased or sold or at any other time the preceding business day's closing price as shown by any regularly published reporting or quotation service, *except for security futures contracts (see paragraph (f)(11)(C)(ii)).* If there is no closing price, a member organization may use a reasonable estimate of the market value of the security as of the close of business on the preceding business day.

(3) The term "customer" means any person for whom securities are purchased or sold or to whom securities are purchased or sold whether on a regular way, when issued, delayed or future delivery basis. It will also include

any person for whom securities are held or carried and to or for whom a member organization extends, arranges or maintains any credit. The term will not include the following: (a) A broker or dealer from whom a security has been purchased or to whom a security has been sold for the account of the member organization or its customers, or (b) an "exempted borrower" as defined by Regulation T of the Board of Governors of the Federal Reserve System ("Regulation T"), except for the proprietary account of a broker/dealer carried by a member organization pursuant to Section (e)(6) of this Rule.

(4) The term "designated account" means the account of a bank, trust company, insurance company, investment trust, state or political subdivision thereof, charitable or nonprofit educational institution regulated under the laws of the United States or any state, or pension or profit sharing plan subject to ERISA or of an agency of the United States or of a state or a political subdivision thereof.

(5) The term "equity" means the customer's ownership interest in the account, computed by adding the current market value of all securities "long" and the amount of any credit balance and subtracting the current market value of all securities "short" and the amount of any debit balance. *Any variation settlement received or paid on a security futures contract shall be considered a credit or debit to the account for purposes of equity.*

(6) The term "exempted security" or "exempted securities" has the meaning as in Section 3(a)(12) of the Act.

(7) The term "margin" means the amount of equity to be maintained on a security position held or carried in an account.

(8) The term "person" has the meaning as in Section 3(a)(9) of the Act.

##### (b) Initial Margin

For the purpose of effecting new securities transactions and commitments, the customer shall be required to deposit margin in cash and/or securities in the account which shall be at least the greater of:

(1) the amount specified in Regulation T, *or Rules 400 through 406 under the Act or Rules 41.42 through 41.48 under the Commodity Exchange Act ("CEA");* or

(2) the amount specified in Section (c)(3) of this Rule; or

(3) such greater amount as NASD may from time to time require for specific securities; or

(4) equity of at least \$2,000 except that cash need not be deposited in excess of the cost of any security

purchased (this equity and cost of purchase provision shall not apply to "when distributed" securities in a cash account). The minimum equity requirement for a "pattern day trader" is \$25,000 pursuant to paragraph (f)(8)(B)(iv)a. of this Rule.<sup>4</sup>

Withdrawals of cash or securities may be made from any account which has a debit balance, "short" position or commitments, provided it is in compliance with Regulation T *and Rules 400 through 406 under the Act and Rules 41.42 through 41.48 under the CEA*, and after such withdrawal the equity in the account is at least the greater of \$2,000 (\$25,000 in the case of a "pattern day trader")<sup>5</sup> or an amount sufficient to meet the maintenance margin requirements of this paragraph.

##### (c) Maintenance Margin

The margin that must be maintained in all accounts of customers, except for cash accounts subject to other provisions of this rule, shall be as follows:

(1) 25 percent of the current market value of all securities, *except for security futures contracts*, "long" in the account; plus

(2) \$2.50 per share or 100 percent of the current market value, whichever amount is greater, of each stock "short" in the account selling at less than \$5.00 per share; plus

(3) \$5.00 per share or 30 percent of the current market value, whichever amount is greater, of each stock "short" in the account selling at \$5.00 per share or above; plus

(4) 5 percent of the principal amount or 30 percent of the current market value, whichever amount is greater, of each bond "short" in the account.

(5) *The minimum maintenance margin levels for security futures contracts, long and short, shall be 20 percent of the current market value of such contract. (See paragraph (f) of this Rule for other provisions pertaining to security futures contracts.)*

\* \* \* \* \*

##### (e)(6) Broker/Dealer Accounts

(A) A member may carry the proprietary account of another broker/dealer, which is registered with the Commission, upon a margin basis which is satisfactory to both parties, provided the requirements of Regulation T *and Rules 400 through 406 under the Act and Rules 41.42 through 41.48 under the CEA* are adhered to and the account is not carried in a deficit equity condition. The amount of any

<sup>3</sup> See letter from Gary L. Goldsholle, Associate General Counsel, NASD to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated November 22, 2002 ("Amendment No. 1"). Amendment No. 1 makes technical changes to the proposed rule text.

<sup>4</sup> See Amendment No. 1, *supra* note 3.

<sup>5</sup> *Id.*

deficiency between the equity maintained in the account and the haircut requirements pursuant to SEC Rule 15c3-1 shall be charged against the member's net capital when computing net capital under SEC Rule 15c3-1.

(e)(7) Nonpurpose Credit

In a nonsecurities credit account, a member may extend and maintain nonpurpose credit to or for any customer without collateral or on any collateral whatever, provided:

(A) the account is recorded separately and confined to the transactions and relations specifically authorized by Regulation T;

(B) the account is not used in any way for the purpose of evading or circumventing any regulation of NASD or of the Board of Governors of the Federal Reserve System and Rules 400 through 406 under the Act and Rules 41.42 through 41.48 under the CEA; and

(C) the amount of any deficiency between the equity in the account and the margin required by the other provisions of this paragraph shall be

charged against the member's net capital as provided in SEC Rule 15c3-1.

The term "nonpurpose credit" means an extension of credit other than "purpose credit," as defined in Section 220.2 of Regulation T.

\* \* \* \* \*

(f)(11) Customer Margin Rules Relating to Security Futures

(A) *Applicability.* No member may effect a transaction involving, or carry an account containing, a security futures contract with or for a customer in a margin account, without obtaining proper and adequate margin as set forth in this section.

(B) *Amount of customer margin.*

(i) *General Rule.* As set forth in paragraphs (b) and (c) of this rule, the minimum initial and maintenance margin levels for each security futures contract, long and short, shall be twenty (20) percent of the current market value of such contract.

(ii) *Excluded from the rule's requirements* are arrangements between a member and a customer with respect

to the customer's financing of proprietary positions in security futures, based on the member's good faith determination that the customer is an "Exempted Person," as defined in Rule 401(a)(9) under the Act, and Rule 41.43(a)(9) under the CEA, except for the proprietary account of a broker/dealer carried by a member pursuant to paragraph (e)(6)(A) of this Rule. Once a registered broker or dealer, or member of a national securities exchange ceases to qualify as an "Exempted Person," it shall notify the member of this fact before establishing any new security futures positions. Any new security futures positions will be subject to the provisions of this paragraph.

(iii) *Permissible Offsets.*

Notwithstanding the minimum margin levels specified in paragraph (f)(11)(B)(i) of this Rule, customers with offset positions involving security futures and related positions may have initial or maintenance margin levels (pursuant to the offset table below) that are lower than the levels specified in paragraph (f)(11)(B)(i) of this Rule.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
(1) Long security future (or basket of security futures representing each component of a narrow-based securities index) and long put option on the same underlying security (or index).	Individual stock or narrow-based security index.	20 percent of the current market value of the long security future, plus pay for the long put in full.	The lower of: (1) 10 percent of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, if any; or (2) 20 percent of the current market value of the long security future.
(2) Short security future (or basket of security futures representing each component of a narrow-based securities index) and short put option on the same underlying security (or index).	Individual stock or narrow-based security index.	20 percent of the current market value of the short security future, plus the aggregate put in-the-money amount, if any. Proceeds from the put sale may be applied.	20 percent of the current market value of the short security future, plus the aggregate put in-the-money amount, if any.
(3) Long security future and short position in the same security (or securities basket) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the short stock or stocks.	5 percent of the current market value as defined in Regulation T of the stock or stocks underlying the security future
(4) Long security future (or basket of security futures representing each component of a narrow-based securities index) and short call option on the same underlying security (or index).	Individual stock or narrow-based security index.	20 percent of the current market value of the long security future, plus the aggregate call in-the-money amount, if any. Proceeds from the call sale may be applied.	20 percent of the current market value of the long security future, plus the aggregate call in-the-money amount, if any.
(5) Long a basket of narrow-based security futures that together tracks a broad based index and short a broad-based security index call option contract on the same index.	Narrow-based security index .....	20 percent of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any. Proceeds from the call sale may be applied.	20 percent of the current market value of the long basket of narrow-based security futures, plus the aggregate call in-the-money amount, if any.
(6) Short a basket of narrow-based security futures that together tracks a broad-based security index and short a broad-based security index put option contract on the same index.	Narrow-based security index .....	20 percent of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any. Proceeds from the put sale may be applied.	20 percent of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
(7) Long a basket of narrow-based security futures that together tracks a broad-based security index <i>and</i> long a broad-based security index put option contract on the same index.	Narrow-based security index .....	20 percent of the current market value of the long basket of narrow-based security futures, plus pay for the long put in full.	The lower of: (1) 10 percent of the aggregate exercise price of the put, plus the aggregate put out-of-the-money amount, if any; or (2) 20 percent of the current market value of the long basket of security futures.
(8) Short a basket of narrow-based security futures that together tracks a broad-based security index <i>and</i> long a broad-based security index call option contract on the same index.	Narrow-based security index .....	20 percent of the current market value of the short basket of narrow-based security futures, plus pay for the long call in full.	The lower of: (1) 10 percent of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20 percent of the current market value of the short security futures.
(9) Long security future <i>and</i> short security future on the same underlying security (or index).	Individual stock or narrow-based security index.	The greater of: (1) 5 percent of the current market value of the long security future; or (2) 5 percent of the current market value of the short security future.	The greater of: (1) 5 percent of the current market value of the long security future; or (2) 5 percent of the current market value of the short security future.
(10) Long security future, long put option <i>and</i> short call option. The long security future, long put and short call must be on the same underlying security and the put and call must have the same exercise price (conversion).	Individual stock or narrow-based security index.	20 percent of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from the call sale may be applied.	10 percent of the aggregate exercise price, plus the aggregate call in-the-money amount, if any.
(11) Long security future, long put option <i>and</i> short call option. The long security future, long put and short call must be on the same underlying security and the put exercise price must be below the call exercise price (Collar).	Individual stock or narrow-based security index.	20 percent of the current market value of the long security future, plus the aggregate call in-the-money amount, if any, plus pay for the put in full. Proceeds from call sale may be applied.	The lower of: (1) 10 percent of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, if any, or (2) 20 percent of the aggregate exercise price of the call, plus aggregate call in-the-money amount, if any.
(12) Short security future <i>and</i> long position in the same security (or securities basket) underlying the security future.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long security or securities.	5 percent of the current market value, as defined in Regulation T, of the long stock or stocks.
(13) Short security future <i>and</i> long position in a security immediately convertible into the same security future, without restriction, including the payment of money.	Individual stock or narrow-based security index.	The initial margin required under Regulation T for the long security or securities.	10 percent of the current market value, as defined in Regulation T, of the long stock or stocks.
(14) Short security future (or basket of security futures representing each component of a narrow-based securities index) <i>and</i> long call option or warrant on the same underlying security (or index).	Individual stock or narrow-based securities index.	20 percent of the current market value of the short security future, plus pay for the call in full.	The lower of: (1) 10 percent of the aggregate price of the call, plus the aggregate call out-of-money amount, if any; or (2) 20 percent of the current market value of the short security security future.
(15) Short security future, short put option long call option. The short security future, short put and long call must be on the same underlying security and the put and call must have the same exercise price. (Reverse Conversion).	Individual stock or narrow-based security index.	20 percent of the current market value of the short security future, plus the aggregate put in-the-money amount, if any, plus pay for the call in full. Proceeds from put sale may be applied.	10 percent of the aggregate exercise price, plus the aggregate put in-the-money amount, if any.
(16) Long (short) a security future <i>and</i> short (long) an identical <sup>6</sup> security future traded on a different market.	Individual stock and narrow-based security index.	The greater of: (1) 3 percent of the current market value of the long security future(s); or (2) 3 percent of the current market value of the short security future(s).	The greater of: (1) 3 percent of the current market value of the long security future(s); or (2) 3 percent of the current market value of the short security future(s).
(17) Long (short) a basket of security futures that together tracks a narrow-based index and short (long) a narrow-based index future.	Individual stock and narrow-based security index.	The greater of: (1) 5 percent of the current market value of the long security future(s); or (2) 5 percent of the current market value of the short security future(s).	The greater of: (1) 5 percent of the current market value of the long security future(s); or (2) 5 percent of the current market value of the short security future(s).

**Note:** <sup>6</sup>Two security futures contract will be considered “identical” for this purpose if they are issued by the same clearing agency of cleared and guaranteed by the same derivatives clearing organization, have identical specifications, and would offset each other at the clearing level. See Amendment No.1, *Supra* note 3.

(C) *Definitions.* For the purposes of paragraph (f)(11) of this Rule and the offset table noted above, with respect to the term “security futures contracts,” the following terms shall have the meanings specified below:

(i) The term “security futures contract” means a “security future” as defined in Section 3(a)(55) of the Act.

(ii) The term “current market-value” has the same meaning as defined in Rule 401(a)(4) under the Act and Rule 41.43(a)(4) under the CEA.

(iii) The term “underlying security” means, in the case of physically settled security futures contracts, the security that is delivered upon expiration of the contract, and, in the case of cash settled security futures contracts, the security or securities index the price or level of which determines the final settlement price for the security futures contract upon its expiration.

(iv) The term “underlying basket” means, in the case of a securities index, a group of security futures contracts where the underlying securities as defined in subparagraph (iii) above include each of the component securities of the applicable index and that meets the following conditions: (1) the quantity of each underlying security is proportional to its representation in the index, (2) the total market value of the underlying securities is equal to the aggregate value of the applicable index, (3) the basket cannot be used to offset more than the number of contracts or warrants represented by its total market value, and (4) the security futures contracts shall be unavailable to support any other contract or warrant transaction in the account.

(v) The term “underlying stock basket” means a group of securities that includes each of the component securities of the applicable index and that meets the following conditions: (1) The quantity of each stock in the basket is proportional to its representation in the index, (2) the total market value of the basket is equal to the underlying index value of the index options or warrants to be covered, (3) the securities in the basket cannot be used to cover more than the number of index options or warrants represented by that value, and (4) the securities in the basket shall be unavailable to support any other option or warrant transaction in the account.

(vi) The term “variation settlement” has the same meaning as defined in

Rule 401(a) under the Act and Rule 41.43(a)(32) under the CEA.

(D) *Security Futures Dealers’ Accounts.*

(i) Notwithstanding the other provisions of this paragraph (f)(11), a member may carry and clear the market maker permitted offset positions (as defined below) of one or more security futures dealers in an account that is limited to bona fide market maker transactions, upon a “Good Faith” margin basis that is satisfactory to the concerned parties, provided the “Good Faith” margin requirement is not less than the Net Capital haircut deduction of the member carrying the transaction pursuant to Rule 15c3-1 under the Act. In lieu of collecting the “Good Faith” margin requirement, a carrying member may elect to deduct in computing its Net Capital the amount of any deficiency between the equity maintained in the account and the “Good Faith” margin required.

For the purpose of this paragraph (f)(11)(D), the term “security futures dealer” means a security futures dealer as defined in Rule 400 (c)(2)(v) under the Act and Rule 41.42(c)(2)(v) under the CEA.

(ii) For purposes of this paragraph (f)(11)(D), a permitted offset position means in the case of a security futures contract in which a security futures dealer makes a market, a position in the underlying asset or other related assets, or positions in options overlying the asset or related assets. Accordingly, a security futures dealer may establish a long or short position in the assets underlying the security futures contracts in which the security futures dealer makes a market, and may purchase or write options overlying those assets if the account holds the following permitted offset positions:

a. A long position in the security futures contract or underlying asset offset by a short option position that is “in or at the money”;

b. A short position in the security futures contract or underlying asset offset by a long option position that is “in or at the money”;

c. A position in the underlying asset resulting from the assignment of a market-maker short option position or making delivery in respect of a short security futures contract;

d. A position in the underlying asset resulting from the assignment of a market-maker long option position or taking delivery in respect of a long security futures contract;

e. A net long position in a security futures contract in which a security futures dealer makes a market or the underlying asset;

f. A net short position in a security futures contract in which a security futures dealer makes a market or the underlying asset; or

g. An offset position as defined in Rule 15c3-1 under the Act, including its appendices, or any applicable SEC staff interpretation or no-action position.

(E) *Approved Options Specialists’ or Market Maker Accounts.*

(i) Notwithstanding the other provisions of (f)(11) and (f)(2)(f), a member may carry and clear the market-maker permitted offset positions (as defined below) of one or more approved options specialists or market-makers in an account that is limited to bona fide approved options specialist or market maker transactions, upon a “Good Faith” margin basis that is satisfactory to the concerned parties, provided the “Good Faith” margin requirement is not less than the Net Capital haircut deduction of the member carrying the transaction pursuant to Rule 15c3-1 under the Act. In lieu of collecting the “Good Faith” margin requirement, a carrying member may elect to deduct in computing its Net Capital the amount of any deficiency between the equity maintained in the account and the “Good Faith” margin required. For the purpose of this paragraph (f)(11)(E), the term “approved options specialist or market-maker” means a specialist, market-maker, or registered trader in options as referenced in paragraph (f)(2)(f) of this Rule, who is deemed a specialist for all purposes under the Act and who is registered pursuant to the rules of a national securities exchange.

(ii) For purposes of this paragraph (f)(11)(E), a permitted offset position means a position in the underlying asset or other related assets. Accordingly, a specialist or market maker may establish a long or short position in the assets underlying the options in which the specialist or market maker makes a market, or a security futures contract thereon, if the account holds the following permitted offset positions:

a. A long position in the underlying instrument or security futures contract offset by a short option position that is “in or at the money”;

b. A short position in the underlying instrument or security futures contract

offset by a long option position that is "in or at the money";

c. A stock position resulting from the assignment of a market-maker short option position or delivery in respect of a short security futures contract;

d. A stock position resulting from the exercise of a market-maker long option position or taking delivery in respect of a long security futures contract;

e. A net long position in a security (other than an option) in which the market maker makes a market;

f. A net short position in a security (other than an option) in which the market maker makes a market; or

g. An offset position as defined in Rule 15c3-1 under the Act, including its appendices, or any applicable SEC staff interpretation or no-action position.

(iii) For purposes of paragraphs (f)(11)(D) and (E), the term "in or at the money" means that the current market price of the underlying security is not more than two standard exercise intervals below (with respect to a call option) or above (with respect to a put option) the exercise price of the option; the term "in the money" means that the current market price of the underlying asset or index is not below (with respect to a call option) or above (with respect to a put option) the exercise price of the option; the term "overlying option" means a put option purchased or a call option written against a long position in an underlying asset; or a call option purchased, or a put option written against a short position in an underlying asset.

(iv) Securities, including options and security futures contracts, in such accounts shall be valued conservatively in light of current market prices and the amount that might be realized upon liquidation. Substantial additional margin must be required or excess Net Capital maintained in all cases where the securities carried: (a) Are subject to unusually rapid or violent changes in value including volatility in the expiration months of options or security futures contracts, (b) do not have an active market, or (c) in one or more or all accounts, including proprietary accounts combined, are such that they cannot be liquidated promptly or represent undue concentration of risk in view of the carrying member's Net Capital and its overall exposure to material loss.

(F) Approved Specialists' Accounts—others.

(i) Notwithstanding the other provisions of (f)(11) and (f)(2)(f), a member may carry the account of an "approved specialist," which account is limited to bona fide specialist transactions including hedge

transactions with security futures contracts upon a margin basis that is satisfactory to both parties. The amount of any deficiency between the equity in the account and haircut requirement pursuant to Rule 15c3-1 shall be charged against the member's net capital when computing net capital under SEC Rule 15c3-1.<sup>7</sup>

(ii) For purposes of this paragraph (f)(11)(F), the term "approved specialist" means a specialist who is deemed a specialist for all purposes under the Act and who is registered pursuant to the rules of a national securities exchange.

(G) Additional Requirements.

(i) Money market mutual funds, as defined in Rule 2a-7 under the Investment Company Act of 1940, can be used for satisfying margin requirements under this paragraph (f)(11), provided that the requirements of Rule 404(b) under the Act and Rule 46(b)(2) under the CEA are satisfied.

(ii) Day trading of security futures is subject to the minimum requirements of this Rule. If deemed a pattern day-trader, the customer must maintain equity of \$25,000. The 20 percent requirement, for security futures contracts, should be calculated based on the greater of the initial or closing transaction and any amount exceeding NASD excess must be collected. The creation of a customer call subjects the account to all the restrictions contained in Rule 2520(f)(8)(B).

(iii) The use of the "time and tick" method is based on the member's ability to substantiate the validity of the system used. Lacking this ability dictates the use of the aggregate method.

(iv) Security futures contracts transacted or held in a futures account<sup>8</sup> shall not be subject to any provision of this Rule.

\* \* \* \* \*

## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

<sup>7</sup> See Amendment No. 1, *supra* note 3.

<sup>8</sup> *Id.*

## A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

### 1. Purpose

### Background

In December 2000, the Commodity Futures Modernization Act of 2000<sup>9</sup> (the "CFMA") was signed into law. The CFMA, among other things, repealed the Shad-Johnson Accord, and now permits, for the first time, the trading of futures on narrow-based indices and single stocks (collectively referred to as "security futures contracts" or "SFCs"). SFCs are hybrid products in that they have characteristics traditionally associated with both securities and futures. Accordingly, the CFMA requires that these products be treated as both "securities" and "futures," and thus they are subject to regulation by the SEC and the CFTC. The enactment of the CFMA surfaced a number of regulatory issues, including determining the appropriate margin treatment for SFCs.

The CFTC and SEC have adopted customer margin requirements for SFCs ("SEC/CFTC Margin Regulations")<sup>10</sup> pursuant to authority delegated to them by the Federal Reserve Board ("FRB") under Section 7(c)(2)(B) of the Act.<sup>11</sup> As noted in the adopting release,<sup>12</sup> Section 7(c)(2) of the Act provides that the customer margin requirements for SFCs must satisfy four requirements: (1) They must preserve the financial integrity of markets trading security futures contracts; (2) they must prevent systemic risk; (3) they must (a) be consistent with the margin requirements for comparable options traded on an exchange registered pursuant to Section 6(a) of the Act,<sup>13</sup> and (b) provide for initial and maintenance margin that are not lower than the lowest level of margin, exclusive of premium, required for comparable exchange traded options; and (4) they must be and remain consistent with the margin requirements established by the FRB under Regulation T.<sup>14</sup> These margin regulations became effective on September 13, 2002. The amendments discussed below are being proposed to conform NASD margin rules to these

<sup>9</sup> Appendix E of Pub. L. No. 106-554, 114 Stat. 2763 (2000).

<sup>10</sup> 17 CFR 242.400 through 406.

<sup>11</sup> 15 U.S.C. 78g(c)(2)(B).

<sup>12</sup> Securities Exchange Act Release No. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002).

<sup>13</sup> 15 U.S.C. 78f.

<sup>14</sup> 12 CFR 220.

new requirements, and to be comparable to those of the NYSE.

### Proposed Rule Change

NASD Rule 2520 prescribes specific margin requirements for members of NASD that must be maintained in all accounts of their customers, based on the type of securities product held in such accounts.

As proposed, NASD Rule 2520(b) and (c) would be amended to provide that the amount of initial and maintenance margin required for long and short SFCs held in a securities account shall be 20 percent of the current market value of such SFC. In doing so, NASD believes this would essentially make margin requirements for SFCs consistent with the margin requirements for comparable exchange-traded options contracts, which are premium plus 20 percent of the underlying securities.

NASD Rule 2520(e)(6) ("Broker/Dealer Accounts") is being amended to permit introducing broker/dealers trading SFCs to deduct from their proprietary accounts the amount of any deficiency between the equity in the account and the haircut requirements pursuant to Rule 15c3-1 under the Act ("Net Capital Rule")<sup>15</sup> in computing the net capital of the member, in lieu of collecting margin.

NASD Rule 2520(f)(11) ("Customer Margin Rules Relating to Security Futures") is a new provision that will provide that transactions in SFCs in a securities account be subject to all other provisions of NASD Rule 2520, including Rule 2520(f)(8)(B) ("Day Trading"). Excluded from the margin requirements of the Rule are arrangements between a creditor and a borrower, whereby the borrower is defined as an "Exempted Person" under Rule 401(a)(9)<sup>16</sup> of the Act, and Rule 41.43(a)(9)<sup>17</sup> under the Commodity Exchange Act. SFCs transacted in a futures account would not be subject to the requirements of NASD Rule 2520.

NASD Rule 2520(f)(11)(B)(iii) ("Permissible Offsets") is a new provision that will permit margin lower than the 20 percent general requirement, and thereby recognize the hedged nature of certain offsetting positions involving SFCs and related positions. In doing so, margin levels for offsetting positions involving SFCs and related positions would be lower than would be required if those positions were margined separately. Further, the proposed rule change makes NASD's Rule consistent with the table of offsets included in the

recently adopted SEC/CFTC margin regulations noted above.

NASD Rule 2520(f)(11)(C) is a new provision that would provide certain definitions that apply specifically to SFCs including, among other things, the definitions of "security futures contract," "current market value," and "underlying security."

NASD Rule 2520(f)(11)(D) ("Security Futures Dealers' Accounts"), NASD Rule 2520(f)(11)(E) ("Approved Options Specialists' or Market Maker's Accounts"), and NASD Rule 2520(f)(11)(F) ("Approved Specialists' Accounts—others") are new rule provisions. As proposed, the rule would permit "good faith" margin treatment for specified hedged offset positions carried in the accounts noted above. However, unlike the amendments proposed by other SROs<sup>18</sup> on security futures, NASD believes that its proposal will permit members to accord offset treatment in accounts carried for such specialists, market makers and security futures dealers only when their activity is limited to bona fide specialist or market making transactions. According to NASD, the limitations imposed are consistent with NASD's belief that market makers bear the primary responsibility and obligation to maintain fair and orderly markets, and provide liquidity to the marketplace. Were a revenue or other test substituted for the affirmative obligation standard here proposed, NASD believes that entities other than qualified market makers would be permitted to receive the more favorable market maker margin treatment. NASD believes that such was not the Commission's or CFTC's intent when adopting these rules.

NASD Rule 2520(f)(11)(G)(i) is a new proposed provision that would permit money market mutual funds as defined in Rule 2a-7 under the Investment Company Act of 1940 to be used for satisfying margin requirements for securities transactions, provided that the requirements of Rule 404(b)<sup>19</sup> under the Act and Rule 41.46(b)(2)<sup>20</sup> under the CEA are satisfied. Presently, money market mutual funds may be used as collateral to satisfy margin requirements under Regulation T in a securities margin account. The amendments to NASD Rule 2520 would now permit the use of such funds as collateral for SFCs as is required by the new SEC/CFTC Margin Regulations described above.

Except as otherwise intended, NASD believes that these proposed amendments are consistent with other SRO rule amendments addressing margin requirements for SFCs (*i.e.*, Nasdaq-Liffe Markets, OneChicago, LLC).

### 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,<sup>21</sup> which requires, among other things, that NASD's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest by establishing margin rules for security futures that are comparable with those developed by the SEC and CFTC and proposed by other SROs.

### B. Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

### II. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

### III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities

<sup>18</sup> See *e.g.*, Securities Exchange Release No. 46555 (September 26, 2002), 67 FR 61707 (October 1, 2002).

<sup>19</sup> 12 CFR 242.404(b).

<sup>20</sup> 12 CFR 41.46(b)(2).

<sup>21</sup> 15 U.S.C. 78o-3(b)(6).

<sup>15</sup> 17 CFR 240.15c3-1.

<sup>16</sup> 17 CFR 242.401(a)(9).

<sup>17</sup> 17 CFR 41.43(a)(9).



and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change 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 in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of NASD. All submissions should refer to the File No. SR-NASD-2002-166 and in the caption above and should be submitted by January 14, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>22</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

[FR Doc. 02-32318 Filed 12-23-02; 8:45 am]

BILLING CODE 8010-01-P

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47008; File No. SR-NASD-2002-153]

### Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. To Extend Manning Protection to Customer Limit Orders in All Securities Quoted on the Over-the-Counter Bulletin Board on a Permanent Basis

December 16, 2002.

#### I. Introduction

On October 25, 2002, the National Association of Securities Dealers, Inc. ("NASD"), through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission"), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to make permanent NASD Rule 6541, which currently is operating on a pilot basis. NASD Rule 6541 provides Manning protection to customer limit orders in approximately 325 securities quoted on the Over-the-Counter Bulletin

Board ("OTCBB"). The proposal was published for comment in the **Federal Register** on November 15, 2002.<sup>3</sup> The Commission received no comments on the proposal. On December 16, 2002, the NASD (through Nasdaq) filed Amendment No. 1 to the proposal.<sup>4</sup> This notice and order solicits comment on the proposed rule change, as revised by Amendment No. 1, and approves the amended proposal on an accelerated basis.

#### II. Description of Proposed Rule Change and Amendment No. 1

NASD Rule 6541 is an investor protection tool based on NASD Interpretive Material ("IM") 2110-2 (commonly known as the "Manning Rule"). In the original *Manning* case, the NASD found, and the Commission affirmed, that a member firm that accepts a customer limit order has a fiduciary duty to refrain from trading for its own account at a price more favorable than the customer's order.<sup>5</sup> NASD Rule 6541 currently extends customer limit order protection to approximately 325 securities quoted on the OTCBB on a pilot basis.<sup>6</sup> NASD Rule 6541(a) prohibits an NASD member that accepts a customer limit order in these securities from "trading ahead" of the limit order for its own account at prices equal or superior to the limit order, without first executing the limit order. NASD Rule 6541(b) permits a member to avoid the obligation in paragraph (a) through the provision of price improvement. If a customer limit order

<sup>3</sup> See Securities Exchange Act Release No. 46783 (November 7, 2002), 67 FR 69279.

<sup>4</sup> See letter from Jeffrey S. Davis, Nasdaq, to Nancy J. Sanow, Division of Market Regulation, Commission, dated December 13, 2002 ("Amendment No. 1"). Amendment No. 1 would revise paragraph (e) of NASD Rule 6541 to remove: (1) A provision specifying the date of the rule's expiration; and (2) a provision limiting the rule only to OTCBB securities that are expressly identified as being subject to the rule. These provisions are no longer necessary in light of the NASD's proposal to extend limit order protection to all OTCBB securities on a permanent basis.

<sup>5</sup> See *In re E.F. Hutton & Co.*, Securities Exchange Act Release No. 25887 (July 6, 1988) ("Manning").

<sup>6</sup> See Securities Exchange Act Release No. 43944 (February 8, 2001), 66 FR 10541 (February 15, 2001) (approving SR-NASD-00-22). See also Securities Exchange Act Release No. 44593 (July 26, 2001), 66 FR 40304 (August 2, 2001) (SR-NASD-2001-39) (amending the price improvement provisions of NASD Rule 6541); Securities Exchange Act Release No. 45011 (November 1, 2001), 66 FR 56587 (November 8, 2001) (SR-NASD-2001-78) (further amending the price improvement provisions); Securities Exchange Act Release No. 45276 (January 14, 2002), 67 FR 2936 (January 22, 2002) (SR-NASD-2002-06) (extending pilot period for NASD Rule 6541 for an additional six months); Securities Exchange Act Release No. 46248 (July 24, 2002), 67 FR 49727 (July 31, 2002) (SR-NASD-2002-95) (extending pilot period for NASD Rule 6541 for an additional six months).

is priced at or inside the current inside spread, the price improvement must be for a minimum of the lesser of \$0.01 or one-half of the current inside spread.<sup>7</sup>

NASD Rule 6541(c) provides that, notwithstanding the obligation in paragraph (a), a member may negotiate specific terms and conditions applicable to the acceptance of the limit orders of institutional accounts and of orders greater than 10,000 shares and \$20,000 in value. NASD Rule 6541(d) provides that a member that trades through a held limit order must execute such limit order contemporaneously, but in no case later than five minutes after the member has traded at a price more favorable than the customer's price. NASD Rule 6541(e) provides that the rule applies from 9:30 a.m. until 4 p.m. Eastern Time, and that the rule applies regardless of whether the subject security is also quoted in another quotation medium.

During the pilot period, Nasdaq's Department of Economic Research analyzed the impact of the pilot on relevant aspects of the OTCBB's operation. Nasdaq reported that the Department's study found no material impact on market quality (as measured by trading activity, market maker quoting activity, and spread behavior) for the securities subject to the pilot.

Nasdaq now seeks to establish NASD Rule 6541 on a permanent basis and to extend Manning protection to customer limit orders in all securities quoted on the OTCBB. In addition, consistent with this proposal, Nasdaq in Amendment No. 1 proposed to eliminate two existing provisions of NASD Rule 6541(e), which provide that the current pilot applies only to certain securities for a specified time period. As revised by Amendment No. 1, NASD Rule 6541 would appear as follows:

#### Rule 6541 Limit Order Protection

(a)-(d) No change.

#### (e) Application

[(1) This rule shall apply only to OTCBB securities specifically identified as such through the Nasdaq Workstation service.]

[(1[2]) This rule shall apply, regardless of whether the subject security is additionally quoted in a separate quotation medium.

[(2[3]) This rule shall apply from 9:30 a.m. to 4 p.m. Eastern Time.

[(4) This rule shall be in effect until December 15, 2002.]

\* \* \* \* \*

<sup>7</sup> For purposes of NASD Rule 6541(b), the inside spread is defined as the difference between the best reasonably available bid and offer in the subject security.

<sup>22</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.