

customer margin requirements for SFCs must satisfy four requirements: (1) They must preserve the financial integrity of markets trading SFCs; (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.

Subsequent to the adoption of the SEC/CFTC Margin Regulations, NASD filed proposed amendments to NASD rule 2520.<sup>15</sup> On January 24, 2003, the Commission approved the amendments on a pilot basis until March 6, 2003.<sup>16</sup> On March 5, 2003, the Commission extended the Pilot until March 20, 2003, to allow the Pilot to permit customers to continue trading SFCs on an uninterrupted basis in securities accounts while NASD considered the comments it received on the Pilot.<sup>17</sup>

Among the amendments approved as part of the Pilot was new NASD rule 2520(f)(11) ("Customer Margin Rules Relating to Security Futures"), which provides that SFCs transacted in a securities account be subject to all other provisions of NASD rule 2520, including 2520(f)(8)(B) ("Day Trading"). Also approved as part of the Pilot were NASD rule 2520(f)(11)(D) ("Security Futures Dealers' Accounts"), rule 2520(f)(11)(E) ("Approved Options Specialists' or Market Makers' Accounts"), and rule 2520(f)(11)(F) ("Approved Specialists' Accounts—others"). Under the Pilot, NASD rule 2520 permits "good faith" margin treatment for specified hedged offset positions carried in the accounts noted above.

However, unlike the SFD rules of other SROs,<sup>18</sup> The Pilot permits members to accord offset treatment in accounts carried for such specialists,

market makers, and SFDs only when their activity is limited to bona fide specialist or market making transactions. 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.

#### Discussion of Comments Received

NASD received one comment letter on the Pilot from the Chicago Board Options Exchange, Inc. ("CBOE").<sup>19</sup> In its letter, the CBOE requested that the Commission not grant permanent approval of NASD's rule as proposed and approved on a pilot basis, unless NASD amended the rule to exempt SFCs from its day trading provisions and deleted references to the term "bona fide" in connection with market maker or specialist transactions.

Under the proposed rule change, NASD's day trading margin requirements would apply to SFCs carried in securities accounts. The CBOE believes that day trading provisions should not apply to such accounts because it would create a disparity that the CFMA was designed to eliminate. In this regard, CBOE's letter states that the SEC and CFTC did not impose day trading margin requirements on SFCs carried in futures and securities accounts. The CBOE argues that since similar margin rules recently approved by the Commission do not impose day trading margin requirements on SFCs carried in futures accounts, permanent approval of NASD's proposed rule would lead to a regulatory disparity the CFMA was designed to prevent.

NASD states that, in proposing its rule amendment on the application of day trading margin requirements to SFCs carried in securities accounts, it did not intend to create a regulatory disparity with other SRO rules. However, NASD notes that SRO rules can be more stringent than those of the Commission.

<sup>19</sup> See letter from Edward J. Joyce, President and Chief Operating Officer ("COO"), CBOE, to Jonathan G. Katz, Secretary, Commission, dated December 20, 2002. CBOE's December 20, 2002 comment letter on NASD's Pilot is a resubmission of its December 9, 2002 comment letter regarding the NYSE's proposed amendments to NYSE Rule 431 relating to margin requirements for security futures contracts. See Securities Exchange Act Release No. 46782 (November 7, 2003), 67 FR 69052 (November 14, 2002) (SR-NYSE-2002-53). The CBOE stated that because the proposed amendments were so similar in nature, its comments on the NYSE's proposed amendments were applicable to NASD's proposed rule change. On March 6, 2003, the Commission approved on a permanent basis amendments to NYSE Rule 431 to incorporate security futures contracts. Securities Exchange Act Release No. 47460, 68 FR 12123 (March 13, 2003) (SR-NYSE-2003-05).

While NASD is guided by the Commission's rules in proposing its rules, NASD has latitude to promulgate more stringent rules when it believes they are necessary for the protection of investors. In this regard, NASD believes that the application of day trading margin requirements of NASD rule 2520 to SFCs is consistent with the treatment of all securities transacted in a margin account under this rule. Accordingly, NASD proposes to apply NASD's day trading margin requirements to SFCs carried in securities accounts.

The CBOE also believes that NASD should delete the term "bona fide" in connection with market maker or specialist transactions. The CBOE commented that NASD does not define the term "bona fide" nor does it use the term in relation to the other provisions of its margin rule relating to market maker and specialist transactions.

In response to these comments, NASD is proposing to amend the rule text by deleting the term "bona fide" in connection with specialist or market maker transactions. In proposing such language under the Pilot, it was NASD's intent to permit good faith margin treatment for off-setting positions that were effected by specialists or market makers in discharging the primary responsibilities noted above in its original filing, rather than to permit persons other than qualified market makers to act in such a capacity—hence, the term "bona fide" in connection with specialist and market making transactions. Upon consideration, and in order to be consistent with similar rules proposed by other SROs, NASD will not use the term "bona fide" and instead incorporate the definition of an SFD as referenced in rule 400(c)(2)(v)<sup>20</sup> under the Act to clarify what constitutes a SFD for purposes of the rule. Notwithstanding this amendment, NASD reiterates that good faith margin treatment will be permitted only for transactions effected by SFDs in discharging their responsibilities and obligations to maintain fair and orderly markets, and to provide liquidity to the marketplace.

#### 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 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.

<sup>20</sup> 17 CFR 240.400(c)(2)(v).

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

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

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

<sup>15</sup> On March 6, 2003, the Commission approved a proposed rule change by the NYSE to adopt, on a permanent basis, margin requirements for security futures contracts pursuant to NYSE Rule 431. See Securities Exchange Act Release No. 47460, 68 FR 12123 (March 13, 2003) (SR-NYSE-2003-05).

<sup>16</sup> See *supra* note 3.

<sup>17</sup> See *supra* note 4.

<sup>18</sup> See e.g., Securities Exchange Act Release No. 46555 (September 26, 2002), 67 FR 61707 (October 1, 2002) (SR-OC-2002-01).