

2 to the proposed rule change.⁷ This order approves the proposed rule change, as amended, on a pilot basis until March 6, 2003.

II. Description of the Proposed Rule Change

NASD is proposing to amend NASD rule 2520 ("Margin Requirements") to establish margin requirements for security futures contracts ("SFCs"). The proposed rule change is being made to make NASD's margin rule consistent with the margin rules for security futures adopted by the SEC and the Commodity Futures Trading Commission ("CFTC"), and the rules adopted by the NYSE, Nasdaq-Liffe Markets, and One Chicago, LLC.

The CFTC and SEC adopted customer margin requirements for SFCs ("SEC/CFTC Margin Regulations")⁸ pursuant to authority delegated to them by the Federal Reserve Board ("FRB") under section 7(c)(2)(B) of the Act.⁹ These margin regulations became effective on September 13, 2002. NASD is proposing to conform its margin rules to these new requirements, and to be comparable to the NYSE's margin requirements under NYSE rule 431.

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 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.

NASD rule 2520(e)(6) ("Broker/Dealer Accounts") would 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")¹⁰ 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") would 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)¹¹ of the Act, and rule 41.43(a)(9)¹² 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") would 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.

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") would permit "good faith" margin treatment for specified hedged offset positions carried in the accounts noted above.¹³ NASD rule

2520(f)(11)(G)(i) 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)¹⁴ under the Act and rule 41.46(b)(2)¹⁵ under the CEA are satisfied.¹⁶

III. Summary of Comments

As noted above, the Commission received one comment letter on the proposed rule change.¹⁷ This commenter also submitted a comment letter on NYSE's proposal regarding margin requirements for securities futures contracts.¹⁸ First, the commenter believes that both the NYSE and NASD rules on margin requirements for security futures should not be approved by the Commission on a permanent basis until the rules provide an exemption from the existing day trading provisions of NYSE rule 431. The commenter believes that applying the margin restrictions on day trading to security futures will create a disparity between security futures contracts that are held in a securities account and contracts that are held in a futures account, which is inconsistent with the principles of the Commodity Futures Modernization Act.

Second, the commenter would like to delete references in the proposed rule language to "bona fide" market maker or specialist transactions. Specifically, the commenter believes that the NYSE and NASD intend to determine which transactions of a "bona fide" market maker/specialist would fit within this definition. The commenter is concerned that NYSE and NASD may not rely on the other self-regulatory organizations' ("SROs") rules regarding who is a market maker and that, therefore, the NYSE's and NASD's rules would not be consistent with the rules of these other SROs. This commenter believes that if the SEC approves an SRO rule regarding who as a market maker, the NYSE and NASD margin rules should defer to that SRO's rule in defining a market maker or specialist.

In response to these substantive concerns, NASD has requested that its proposal be approved as a pilot under

⁷ See letter from Gary L. Goldsholle, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Division, Commission, dated January 15, 2003 ("Amendment No. 2"). In Amendment No. 2, NASD requested that the Commission approve the proposed rule change on a pilot basis under the same terms as the NYSE's pilot, pending the resolution of the issues raised by commenters.

⁸ 17 CFR 242.400 through 406; 17 CFR 41.42 through 41.48.

⁹ 15 U.S.C. 78g(c)(2)(B). As noted in the adopting release, 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 (15 U.S.C. 78f) 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. See Securities Exchange Act Release no. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002).

¹⁰ 17 CFR 240.15c3-1.

¹¹ 17 CFR 242.401(a)(9).

¹² 17 CFR 41.43(a)(9).

¹³ NASD noted that, unlike the amendments proposed by other SROs, on security futures, it believes that its proposed amendment 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 the SEC/CFTC Margin Regulations.

¹⁴ 17 CFR 242.404(b).

¹⁵ 17 CFR 41.46(b)(2).

¹⁶ 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.

¹⁷ See *supra* note .

¹⁸ For further details on SR-NYSE-2002-53, see *id.*