

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and national market system, and, in general, to protect investors and the public interest.

The Commission believes that the proposed rule change should allow specialists to disseminate the actual depth of the NYSE auction market, while still ensuring that Direct+ is available when there is sufficient liquidity at prices closely related to the last sale.⁹ The Commission also believes that the proposed rule change should continue to accommodate the crossing of block transactions outside the prevailing quote, at the same time ensuring that limit orders that are received while the block trade is being effected that improve the market represented by the broker-dealer's bid or offer on behalf of the Rule 127 trade will be executed as part of the block transaction.

III. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,¹⁰ that the proposed rule change (SR-NYSE-2002-44) is approved as part of the NYSE Direct+ pilot that expires on December 23, 2003.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹¹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-47460; File No. SR-NYSE-2003-05]

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change by the New York Stock Exchange, Inc. To Adopt, on a Permanent Basis, Margin Requirements for Security Futures Contracts

March 6, 2003.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 5, 2003, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") filed with the Securities and Exchange Commission ("SEC" or the "Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to grant accelerated approval of the proposed rule change.

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

This Exchange proposes to adopt, on a permanent basis, the amendments to NYSE Rule 431 relating to margin requirements for Security Futures Contracts ("SFCs"), which were approved by the SEC on a pilot basis for sixty days (the "Pilot") on November 7, 2002,³ and the Pilot was extended for an additional sixty days, from January 6, 2003 until March 6, 2003.⁴

The Exchange believes that the proposed rule change would make its margin rule consistent with margin rules already adopted by the SEC and the Commodity Futures Trading Commission ("CFTC") and those filed by other self-regulatory organizations ("SROs") regarding security futures.

Specifically, the proposed amendments would: (1) Permit customer margining of SFCs, and establish initial and maintenance margin requirements for SFCs; (2) allow for initial and maintenance margin levels for offsetting positions involving

SFCs and related positions at lower levels than would be required if margined separately; (3) provide for a Market Maker exclusion for proprietary trades of a Security Futures Dealer ("SFD") and allow for "good faith" margin treatment for the accounts of approved options specialists, market makers and other specialists; (4) provide definitions relative to SFCs for application of this rule; (5) provide that SFCs transacted in a futures account shall not be subject to any provisions of Rule 431; (6) provide for money market mutual funds as defined under Rule 2a-7⁵ of the ICA,⁶ to be used to satisfy margin requirements for SFCs provided certain conditions are met; (7) require that SFCs transacted in a securities account be subject to all other provisions of NYSE Rule 431, particularly Rule 431(f)(8)(B) ("Day Trading"); and (8) permit members and member organizations for which the Exchange is the Designated Examining Authority ("DEA") to participate in the trading of SFCs.

Below is the text of the proposed rule change. Proposed new language is italicized; proposed deletions are in brackets. In addition, the table of offsets is new rule language.

* * * * *

Rule 431 ("Margin Requirements")

Rule 431. (a) For purposes of this Rule, the following terms shall have the meanings specified below:

(1) 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 Section (f)(10)(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.

Rule 431 (a)(2) through (a)(3) unchanged.

(4) 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.*

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Securities Exchange Act Release No. 46782 (November 7, 2002), 67 FR 69052 (November 14, 2002) (SR-NYSE-2002-53).

⁴ See Securities Exchange Act Release No. 47129 (January 3, 2003), 68 FR 2094 (January 15, 2003) (SR-NYSE-2003-01).

⁵ 17 CFR 270.2a-7.

⁶ 15 U.S.C. 80a et seq.

⁹ According to the Exchange, a high percentage of executions in Direct+ occur within five cents of the last sale. See Amendment No. 1, *supra* note 3.

¹⁰ *Id.*

¹¹ 17 CFR 200.30-3(a)(12).

(5) The term “exempted security” or “exempted securities” has the meaning as in Section 3(a)(12) of the Securities Exchange Act of 1934 (*the “Exchange Act”* or *“SEA”*).

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

(7) The term “person” has the meaning as in Section 3(a)(9) of the [Securities Exchange Act of 1934] *Exchange Act*.

(8) The term “basket” shall mean a group of stocks that the Exchange 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.

Initial Margin

(b) 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 of the Board of Governors of the Federal Reserve System *or Rules 400 through 406 of the Exchange Act or Rules 41.42 through 41.48 of The Commodity Exchange Act (“CEA”)*, or

(2) the amount specified in section (c) of this Rule, or

(3) such greater amount as the Exchange 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)(1) of this Rule. 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 of the Board of Governors of the Federal Reserve System *and Rules 400 through 406 of the Exchange Act and Rules 41.42 through 41.48 of 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 “pattern day traders”) or an amount sufficient to meet the maintenance margin requirements of this Rule.

Maintenance Margin

(c) The margin which must be maintained in all accounts of customers, except for cash accounts subject to Regulation T unless a transaction in a cash account is subject to other provisions of this rule, shall be as follows:

(1) 25% 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% 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% 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% of the principal amount or 30% 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% of the current market value of such contract. (See paragraph (f) of this Rule for other provisions pertaining to security futures contracts.)*

Rule 431(d) through (e)(5) unchanged.

(e)(6)(A) Broker/Dealer Accounts.—A member organization may carry the proprietary account of another broker/dealer, which is registered with the Securities and Exchange Commission, upon a margin basis which is satisfactory to both parties, provided the requirements of Regulation T of the Board of Governors of the Federal Reserve System *and Rules 400 through 406 under the Exchange 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 deficiency between the equity maintained in the account and the haircut requirements pursuant to SEA Rule 15c3-1 (Net Capital) shall be deducted in computing the Net Capital of the member organization under the Exchange’s Capital Requirements. However, when computing Net Capital deductions for transactions in securities covered by paragraphs (e)(2)(F) and (e)(2)(G) of this Rule, the respective requirements of those paragraphs may be used, rather than the haircut requirements of SEA Rule 15c3-1.

Rule 431(e)(6)(B) unchanged.

(e)(7) Nonpurpose Credit.—In a nonsecurities credit account, a member organization 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 of the Board of Governors of the Federal Reserve System;

(B) the account is not used in any way for the purpose of evading or circumventing any regulation of the Exchange or of the Board of Governors of the Federal Reserve System *and Rules 400 through 406 under the Exchange 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 Rule shall be deducted by computing the Net Capital of the member organization under the Exchange’s Capital Requirements. (The term “nonpurpose credit” means an extension of credit other than “purpose credit,” as defined in Section 220.2 of Regulation T of the Board of Governors of the Federal Reserve System.)

Rule 431(e)(8) through (f)(9) unchanged.

(f)

(10) *Customer Margin Rules Relating to Security Futures.*

(A) *Applicability.* No member or member organization 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 sections (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 rules’ requirements are arrangements between a member or member organization and a customer with respect to the customer’s financing of proprietary positions in security futures, based on the member’s or member organization’s good faith determination that the customer is an “Exempted Person”, as defined in Rule 401(a)(9) under the Exchange Act, and Rule 41.43(a)(9) of the CEA, except for the proprietary account of a broker-dealer carried by a member organization pursuant to Section (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 or member organization of this fact before establishing any new security futures positions. Any new security futures*

positions will be subject to the provisions of this part.

(iii) Permissible Offsets.—

Notwithstanding the minimum margin

levels specified in paragraph (f)(10)(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)(10)(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% of the current market value of the long security future, plus pay for the long put in full.	The lower of: (1) 10% of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, if any; or (2) 20% 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% 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% 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% 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% 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% 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% 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% 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% 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% of the current market value of the short basket of narrow-based security futures, plus the aggregate put in-the-money amount, if any.
7. Long a basket of narrow-based security futures that together tracks a broad-based security index and long a broad-based security index put option contract the same index.	Narrow-based security index.	20% 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% of the aggregate exercise price of the put, plus the aggregate put out-of-the-money amount, if any; or (2) 20% 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 and long a broad-based security index call option contract on the same index.	Narrow-based security index.	20% 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% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20% of the current market value of the short basket of security futures.
9. Long security future and short security future on the same underlying security (or index).	Individual stock or narrow-based security index.	The greater of: (1) 5% of the current market value of the long security future; or (2) 5% of the current market value of the short security future.	The greater of: 5% of the current market value of the long security future; or (2) 5% of the current market value of the short security future.
10. Long security future, long put option and 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% 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% of the aggregate exercise price, plus the aggregate call in-the-money amount, if any.
11. Long security future, long put option and 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% 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% of the aggregate exercise price of the put plus the aggregate put out-of-the-money amount, if any; or (2) 20% of the aggregate exercise price of the call, plus the aggregate call in-the-money amount, if any.

Description of offset	Security underlying the security future	Initial margin requirement	Maintenance margin requirement
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% 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 underlying the 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% 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 security index.	20% of the current market value of the short security future, plus pay for the call in full.	The lower of: (1) 10% of the aggregate exercise price of the call, plus the aggregate call out-of-the-money amount, if any; or (2) 20% of the current market value of the short security future.
15. Short security future, short put option and 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% 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% 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 security future traded on a different market.	Individual stock and narrow-based security index.	The greater of: (1) 3% of the current market value of the long security future(s); or (2) 3% of the current market value of the short security future(s).	The greater of: (1) 3% of the current market value of the short security future(s); or (2) 3% 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% of the current market value of the short security future(s); or (2) 5% of the current market value of the short security future(s).	The greater of: (1) 5% of the current market value of the short security future(s); or (2) 5% of the current market value of the short security future(s).

⁷ Two security futures contracts will be considered "identical" for this purpose if they are issued by the same clearing agency or cleared and contracts guaranteed by the same derivatives clearing organization, have identical specifications, and would offset each other at the clearing level.

(C) *Definitions.* For the purposes of section (f)(10) 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 Exchange Act.

(ii) The term "current market value" has the same meaning as it is as defined in Rule 401(4) under the Exchange Act and Rule 41.43(a)(4) of 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 paragraph (iii) above include each of the component securities of the applicable index and which 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 which includes each of the component securities of the applicable index and which 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 it is defined in Rule 401(a) of the Exchange Act and Rule 41.43(a)(32) of the CEA.

(D) *Security Futures Dealers' Accounts.* Notwithstanding the other provisions of this section (f)(10), a member organization may carry and clear the market maker permitted offset positions (as defined below) of one or more security future dealers in an account which is limited to market maker transactions, upon a "Good Faith" margin basis which is satisfactory to the concerned parties, provided the "Good Faith" margin requirement is not less than the Net Capital haircut deduction of the member organization carrying the transaction pursuant to Rule 325. In lieu of collecting the "Good Faith" margin requirement, a carrying member organization 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)(10)(D), the term "security futures dealer" means (1) a member or member organization of a national securities

exchange or a national securities association registered pursuant to Section 15A(a) of the Exchange Act; (2) is registered with such exchange or such association as a security futures dealer pursuant to rules that are effective in accordance with Section 19(b)(2) of the Exchange Act and, as applicable, Section 5c(c) of the CEA, that: (1) requires such member or member organization to be registered as a floor trader or a floor broker with the CFTC under Section 4f(a)(1) of the CEA, or as a dealer with the Commission under Section 15(b) of the Exchange Act; (2) or requires such member or member organization to maintain records sufficient to prove compliance with the rules of the exchange or association of which it is a member; (3) requires such member or member organization to hold itself out as being willing to buy and sell security futures for its own account on a regular and continuous basis; and (4) provides for disciplinary action, including revocation of such member's or member organization's registration as a security futures dealer, for such member's or member organization's failure to comply with Rules 400 through 406 of the Exchange Act and Rules 41.42 through 41.49 of the CEA or the rules of the exchange or association of which the security futures dealer is a member or member organization.

For purposes of this paragraph (f)(10)(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 other 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:

- (i) A long position in the security futures contract or underlying asset offset by a short option position which is "in or at the money;"
- (ii) A short position in the security futures contract or underlying asset offset by a long option position which is "in or at the money;"
- (iii) 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;

(iv) 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;

(v) A net long position in a security futures contract in which a security futures dealer makes a market or the underlying asset;

(vi) A net short position in a security futures contract in which a security futures dealer makes a market or the underlying asset; or

(vii) An offset position as defined in SEA Rule 15c3-1, including its appendices, or any applicable SEC staff interpretation or no-action position.

(E) Approved Options Specialists' or Market Makers' Accounts.

Notwithstanding the other provisions of (f)(10) and (f)(2)(j), a member organization 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 which is limited to approved options specialist or market maker transactions, upon a "Good Faith" margin basis which is satisfactory to the concerned parties, provided the "Good Faith" margin requirement is not less than the Net Capital haircut deduction of the member organization carrying the transaction pursuant to Rule 325. In lieu of collecting the "Good Faith" margin requirement, a carrying member organization 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)(10)(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)(j) of this Rule, who is deemed a specialist for all purposes under the Exchange Act and who is registered pursuant to the rules of a national securities exchange.

For purposes of this paragraph (f)(10)(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:

- (i) A long position in the underlying instrument or security futures contract offset by a short option position which is "in or at the money;"
- (ii) A short position in the underlying instrument or security futures contracts offset by a long option position which is "in or at the money;"
- (iii) A stock position resulting from the assignment of a market maker short

option position or delivery in respect of a short security futures contract;

(iv) 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;

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

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

(vii) An offset position as defined in SEC Rule 15c3-1, including the appendices, or any applicable SEC staff interpretation or no-action position.

For purposes of paragraphs (f)(10)(D) and (E), the term "in or at the money" means the current market price of the underlying security is not more than the 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 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; and 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.

Securities, including options and security futures contracts, in such accounts shall be valued conservatively in the light of current market prices and the amount which might be realized upon liquidation. Substantial additional margin must be required or excess Net Capital maintained in all cases where the securities carried: (i) Are subject to unusually rapid or violent changes in value including volatility in the expiration months of options or security futures products, (ii) do not have an active market, or (iii) 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 or member organization's Net Capital and its overall exposure to material loss.

(F) Approved Specialists' Accounts—others. Notwithstanding the other provisions of (f)(10) and (f)(2)(j), a member organization may carry the account of an "approved specialist," which account is limited to specialist transactions including hedge transactions with security futures contracts upon a margin basis which is satisfactory to both parties. The amount of any deficiency between the equity in the account and haircut requirements

pursuant to SEA Rule 15c3-1 (*Net Capital*) shall be deducted in computing the Net Capital of the member organization under the Exchange's Capital Requirements. For purposes of this paragraph (f)(10)(F) the term "approved specialist" means a specialist who is deemed a specialist for all purposes under the Exchange Act and who is registered pursuant to the rules of a national securities exchange.

.70 Money market mutual funds, as defined under Rule 2a-7 of the Investment Company Act of 1940, can be used for satisfying margin requirements under this subsection (f)(10), provided that the requirements of Rule 404(b) of the Exchange Act and Rule 46(b)(2) under the CEA are satisfied.

.80 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% requirement, for security futures contracts, should be calculated based on the greater of the initial or closing transaction and any amount exceeding NYSE excess must be collected. The creation of a customer call subjects the account to all the restrictions contained in Rule 431(f)(8)(B).

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

.100 Security futures contracts transacted or held in a futures account 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, the Exchange 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 and is set forth in Sections A, B, and C below.

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

1. Purpose

The Exchange proposes to make permanent the amendments to NYSE Rule 431 regarding margin requirements for SFCs. The original proposed rule

change to amend NYSE Rule 431 was approved by the Commission on a pilot basis for sixty days on November 7, 2002.⁸ On January 6, 2003, the Commission approved an extension to the Pilot for an additional sixty days, ending March 6, 2003.⁹

The proposed amendments are being made to make the Exchange's margin rule consistent with margin rules already adopted by the SEC and the CFTC and those filed by other SROs regarding security futures.

Specifically, the proposed amendments would: (1) Permit customer margining of SFCs, and establish initial and maintenance margin requirements for SFCs; (2) allow for initial and maintenance margin levels for offsetting positions involving SFCs and related positions at lower levels than would be required if margined separately; (3) provide for a Market Maker exclusion for proprietary trades of a SFD and allow for "good faith" margin treatment for the accounts of approved options specialists, market makers and other specialists; (4) provide definitions relative to SFCs for application of this rule; (5) provide that SFCs transacted in a futures account shall not be subject to any provisions of NYSE Rule 431; (6) provide for money market mutual funds, as defined under Rule 2a-7¹⁰ of the Investment Company Act of 1940,¹¹ to be used to satisfy margin requirements for SFCs provided certain conditions are met; (7) require that SFCs transacted in a securities account be subject to all other provisions of NYSE Rule 431, particularly Rule 431(f)(8)(B) ("Day Trading"); and (8) permit members and member organizations for which the Exchange is the DEA to participate in the trading of SFCs.

Background

The CFTC and SEC have adopted customer margin requirements for the trading of SFCs ("SEC/CFTC Margin Regulations")¹² pursuant to authority delegated to them by the Federal Reserve Board ("FRB") under section 7(c)(2)(B) of the Act.¹³ As noted in the adopting release,¹⁴ new subsection (2) to section 7(c) provides that the customer margin requirements for SFCs must satisfy four requirements: (1) They must preserve the financial integrity of

markets trading security futures products; (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 Exchange Act,¹⁵ 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.¹⁶ The regulations on customer margin for security futures became effective on September 13, 2002. Pursuant to these amendments the Exchange filed proposed amendments to NYSE Rule 431, which were approved temporarily on a pilot basis by the Commission.

Specifically, on October 23, 2002, the Exchange filed a proposed rule change with the Commission to amend NYSE Rule 431 with regard to SFCs.¹⁷ On November 6, 2002, the Exchange filed Amendment No. 1 to the proposed rule change.¹⁸ The proposed rule change was approved by the Commission as a sixty-day pilot on November 7, 2002,¹⁹ effective through January 6, 2003 ("Pilot").

Among the amendments approved, as part of the Pilot, was new NYSE Rule 431(f)(10) ("Customer Margin Rules Relating to Security Futures"), which provides that SFCs transacted in a securities account be subject to all other provisions of NYSE Rule 431, including Rule 431(f)(8)(B) ("Day Trading").

Also approved as part of the Pilot were NYSE Rule 431(f)(10)(D) ("Security Futures Dealers" Accounts"), Rule 431(f)(10)(E) ("Approved Options Specialists' or Market Makers' Accounts"), and Rule 431(f)(10)(F) ("Approved Specialists' Accounts-others"). The rule permits "good faith" margin treatment for specified hedged offset positions carried in the accounts noted above. However, unlike the SFD rules of other SROs,²⁰ the Exchange's

¹⁵ 15 U.S.C. 78f.

¹⁶ 12 CFR part 220.

¹⁷ See SR-NYSE-2002-53.

¹⁸ See letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Nancy Sanow, Assistant Director, Division, Commission, dated November 5, 2002 ("Amendment No. 1"). Amendment No. 1 replaced the original rule filing in its entirety (SR-NYSE-2002-53). Amendment No. 1 also proposed that the proposal be effective for a sixty-day pilot and requested accelerated approval of the proposed rule change.

¹⁹ See Securities Exchange Act Release No. 46782 (November 7, 2002), 67 FR 69052 (November 14, 2002) (SR-NYSE-2002-53).

²⁰ See e.g., Securities Exchange Act Release No. 46555 (September 26, 2002), 67 FR 61707 (October 1, 2002) (SR-OC-2002-01).

⁸ See *supra* note 3.

⁹ See *supra* note 4.

¹⁰ 17 CFR 270.2a-7.

¹¹ 15 U.S.C. 80a *et seq.*

¹² 17 CFR 240.400 through 406; 17 CFR 41.41 through 41.48.

¹³ 15 U.S.C. 78g(c)(2)(B).

¹⁴ See Securities Exchange Act Release No. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002).

Pilot permitted member organizations 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 were consistent with the Exchange's belief that market makers bear the primary responsibility and obligation to maintain fair and orderly markets, and provide liquidity to the marketplace.

On January 3, 2003, the Exchange filed a proposed rule change to extend the Pilot for an additional sixty days (from January 6, 2003 until March 6, 2003) to allow the Pilot to continue in effect on an uninterrupted basis and to permit customers to continue trading SFCs in securities accounts while the Exchange considered the comments discussed below that it had received on the Pilot.²¹

Discussion of Comments Received

On December 9, 2002, the Chicago Board Options Exchange, Incorporated ("CBOE") submitted a comment letter with regard to the Exchange's margin rules for SFCs.²² In its letter, the CBOE requested that the Commission not grant permanent approval of the amendments to NYSE Rule 431 as proposed and approved on a pilot basis, unless the Exchange 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.

In addition, as proposed, the Exchange's day trading margin requirements would apply to SFCs carried in securities accounts. The CBOE believed 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 stated that the SEC and CFTC did not impose day trading margin requirements to SFCs carried in futures and securities accounts. Since similar margin rules recently approved by the Commission do not impose day trading margin requirements on SFCs carried in futures account, the CBOE stated that permanent approval of the Exchange's proposed rule would lead to a regulatory disparity the CFMA was designed to prevent.

The Exchange is now seeking to adopt, on a permanent basis, margin requirements for SFCs carried in securities accounts, with proposed text

modifications from the Pilot based on the comments received and as discussed below.

In proposing its rule amendment on the application of day trading margin requirements to SFCs carried in securities accounts, the Exchange did not intend to create a regulatory disparity with other SROs' rules. However, the Exchange notes that an SRO's rules can be more stringent than those of the Commission. In proposing rules, the Exchange is guided by Commission rules and has latitude to promulgate more stringent rules, which it believes are necessary for the protection of investors. In this regard, NYSE believes that the application of the day trading margin requirements of NYSE Rule 431 as applied to SFCs carried in a securities account is consistent with the treatment of all securities transacted in a margin account under this rule. Accordingly, the Exchange will propose to apply the day trading margin requirements to SFCs carried in a securities account.

The CBOE also believes that the Exchange should delete the term "bona fide" in connection with market maker or specialist transactions. CBOE commented that the Exchange 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 CBOE's comments, the Exchange 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 program, it was the Exchange's intent to permit good faith margin treatment for offsetting 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,²³ the Exchange will not use the term "bona fide" in connection with specialist and market making transactions and instead the Exchange proposes to incorporate the definition of a SFD in Exchange Act Rule 400(c)(2)(v)²⁴ to clarify what constitutes a SFD for purpose of the rule.

Notwithstanding this amendment, the Exchange reiterates that good faith margin treatment be permitted 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

The basis under the Exchange Act for this proposed rule change is section 6(b)(5) of the Act,²⁵ which requires, among other things, that an exchange have rules that are designed to promote just and equitable principles of trade, to remove impediments to, and perfect the mechanism of, a free and open market and a national market system and, in general, to protect investors and the public interest. The Exchange believes that the proposed rule change is designed to accomplish these goals by permitting customers to trade SFCs in securities accounts.

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

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

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

The Exchange notes that it received written comments on the original proposed rule change that was filed with the Commission on October 23, 2002, and thereafter amended on November 6, 2002. The Exchange has responded to such comments, and hereby amends its proposed rule change, which was approved by the Commission as a pilot program.

III. Solicitation of Comments

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

²¹ See *supra* note .

²² See letter from Edward J. Joyce, President and Chief Operating Officer, CBOE, to Jonathan G. Katz, Secretary, Commission, dated December 9, 2002.

²³ See e.g., Securities Exchange Act Release No. 46711 (November 5, 2002), 67 FR 68710 (November 12, 2002).

²⁴ 17 CFR 240.400(c)(2)(v).

²⁵ 15 U.S.C. 78f(b)(5).

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 the NYSE. All submissions should refer to File No. SR-NYSE-2003-05 and should be submitted by April 3, 2003.

IV. Commission Findings and Order Granting Accelerated Approval of a Proposed Rule Change

The NYSE has asked that the Commission approve the proposed rule change prior to the thirtieth day after publication of notice of the filing in the **Federal Register** to accommodate the continuance of trading of security futures in securities accounts pursuant to NYSE Rule 431 on an uninterrupted basis after the Pilot ends on March 6, 2003. The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.²⁶ In particular, the Commission believes that the proposed rule change is consistent with the requirements of section 6(b)(5) of the Act,²⁷ which requires, among other things, that the rules of the Exchange be designed to promote just and equitable principles of trade and, in general, to protect investors and the public interest.²⁸ In addition, the Commission believes that the proposed rule change is consistent with section 7(c)(2)(B) of the Act,²⁹ which provides, among other things, that the margin requirements for security futures must preserve the financial integrity of markets trading security futures, prevent systemic risk, be consistent with the margin requirements for comparable exchange-traded options, and provide that the margin levels for security futures may be no lower than the lowest level of margin, exclusive of premium, required for any comparable exchange-traded option.

The Commission believes that the rule change is generally consistent with the customer margin rules for security futures adopted by the Commission and the CFTC. In particular, the Commission notes that, consistent with Rule 403 under the Act, NYSE's proposed rule

provides for a minimum margin level of 20% of current market value for all positions in security futures carried in a securities account. The Commission believes that 20% is the minimum margin level necessary to satisfy the requirements of section 7(c)(2)(B) of the Act. Rule 403 under the Act³⁰ also provides that a national securities exchange may set margin levels lower than 20% of the current market value of the security future for an offsetting position involving security futures and related positions, provided that an exchange's margin levels for offsetting positions meet the criteria set forth in section 7(c)(2)(B) of the Act. The offsets proposed by NYSE are consistent with the strategy-based offsets permitted for comparable offset positions involving exchange-traded options and therefore consistent with section 7(c)(2)(B) of the Act.

In addition, the Commission believes it is consistent with the Act for the NYSE to exclude from its margin requirements positions in SFCs carried in a futures account. The Commission believes that by choosing to exclude such positions from the scope of Rule 431, the NYSE's proposal will make compliance by members with the regulatory requirements of several SROs easier. Moreover, as proposed, NYSE member organizations will accord "good faith" margin treatment to specified offsetting positions involving security futures, carried in a securities account for a SFD, consistent with the customer margin rules for security futures adopted by the Commission and the CFTC.

After careful consideration of the commenter's concern about applying the NYSE's day trading margin requirements to SFCs, the Commission believes that it is reasonable for the NYSE to impose day trading margin requirements on its members with respect to SFCs carried in a securities account. As NYSE noted, an SRO may adopt more stringent requirements than those promulgated by the Commission.

The Commission has also carefully considered the commenter's concern of using the term "bona fide" with respect to market maker or specialist transactions. The Commission notes that NYSE has deleted the term "bona fide" in reference to market maker or specialist transactions, and instead is incorporating the definition of an SFD in Rule 400(c)(2)(v) under the Act. The Commission believes that if it finds, in approving an SRO's rules for SFDs, that such rules are consistent with the definition of SFD in Rule 400(c)(2)(v),

those rules would also be consistent with NYSE Rule 431(f)(10)(D). Therefore, the Commission believes this amendment should address the commenter's concerns that NYSE not impose a higher standard on transactions by market maker and specialist registered pursuant to rules of another SRO to qualify for favorable margin treatment.

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that accelerated approval of the proposed rule change should enable NYSE members to continue to trade SFCs in securities accounts on an uninterrupted basis. In addition, the Commission believes that granting accelerated approval to the proposed rule change should clarify NYSE members' obligations under NYSE Rule 431 with respect to their trading in SFCs. The Commission notes it approved NYSE's original filing as a temporary pilot to give members of the public an opportunity to comment on the substance of the proposed rule change before it requests permanent approval. The NYSE has responded to the comments received, as described above. Accordingly, the Commission finds good cause, consistent with section 19(b)(2) of the Act, to approve the proposed rule change prior to the thirtieth day after publication if the notice of filing.

V. Conclusion

It is therefore ordered, pursuant to section 19(b)(2) of the Act³¹, that the proposed rule change (File No. SR-NYSE-2003-05) be approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³²

Margaret H. McFarland,
Deputy Secretary.

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²⁶ 15 U.S.C. 78s(b)(2).

²⁷ 15 U.S.C. 78f(b)(5).

²⁸ In approving the proposed rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

²⁹ 15 U.S.C. 78g(c)(2)(B).

³⁰ 17 CFR 240.403(b)(2).

³¹ 15 U.S.C. 78s(b)(2).

³² 17 CFR 200.30-3(a)(12).