trading these securities, and thus enhances investors' opportunities. The Exchange, however, must maintain regulatory oversight over any products listed under the generic listing standards through adequate surveillance. ISE represents that its surveillance procedures are sufficient to detect fraudulent trading among members in the trading of narrow-based index options pursuant to the generic listing and maintenance standards. The Commission believes that these surveillance procedures are adequate to address concerns associated with listing and trading of the narrow-based index options.

The Commission believes that the listing and maintenance standards set forth herein are consistent with the listing and maintenance standards for narrow-based index options that the Amex, CBOE, PCX and the Phlx have developed and are reasonably designed to ensure the protection of investors and the public interest. Specifically, the Commission finds that the generic standards covering minimum capitalization, monthly trading volume, and relative weightings of component stocks are designed to ensure that the trading markets for component stocks are adequately capitalized and sufficiently liquid, and that no one stock or stock group dominates the index. Thus, the Commission believes that the satisfaction of these requirements significantly minimizes the potential for manipulation of the index.

Two other important requirements included in the proposal are that at least 90 percent of the component securities, by weight, and 80 percent of the total number of component securities, must be eligible individually for options trading, and that no more than 20 percent of the weight of the index may be comprised of ADRs that are not subject to a comprehensive surveillance sharing agreement. The Commission believes that these standards are necessary to ensure that index options are not used as surrogate instruments to trade options on stocks and/or ADRs that otherwise are not eligible for options trading.

The Commission also believes that the number of securities required to constitute the narrow-based index is large enough to ensure that an index is not created for the purpose of obtaining more favorable regulatory treatment, *e.g.*, with respect to position and exercise limits, as compared with the trading of options in the underlying stocks.

The Commission also finds the requirements that all securities comprising the index be ''reported securities,'' as defined in Rule 11Aa3–1 under the Act,[24] and that the index value be disseminated at least once every 15 seconds during trading hours of the index, will contribute significantly to the transparency of the market for such index options. The Commission further believes that basing the settlement value of expiring index options upon the opening prices of the component securities on the primary market on which they are listed and traded may help contain the volatility of related markets upon their expiration.

The Commission further notes that ISE's rules that are applicable to narrow-based index options, including provisions addressing sales practices, floor trading procedures, position and exercise limits, margin requirements, and trading halts and suspensions, will continue to apply to any narrow-based index listed pursuant Rule 19b–4(e) under the Act.

The Commission believes that a surveillance sharing agreement between an Exchange proposing to list a stock index derivative product and the exchange(s) trading the stocks underlying the derivative product is an important measure for surveillance of the derivative and underlying securities markets. The Commission believes that such agreements ensure the availability of information necessary to detect and deter potential manipulations and other trading abuses, thereby making the stock index product less readily susceptible to manipulation. When a new derivative securities product based upon domestic securities is listed and traded on an exchange pursuant to Rule 19b–4(e) under the Act, the exchange should determine that the markets upon which all of the U.S. component securities trade are members of the Intermarket Surveillance Group (''ISG''),[25] which provides information relevant to the surveillance of the trading of securities on other market centers.[26] In this regard, all of the registered national securities exchanges, including the ISE, as well as the National Association of Securities Dealers, Inc. (''NASD''), are members of the ISG.

For new derivative securities products based on securities from a foreign market, the SRO should have a comprehensive Intermarket Surveillance Agreement with the market for the securities underlying the new securities product.[27] Accordingly, the Commission finds that the requirement that no more than 20 percent of the weight of the index may be comprised of ADRs that are not subject to a comprehensive surveillance sharing agreement between the particular U.S. exchange and the primary market of the underlying security will continue to ensure that the Exchanges have the ability to adequately surveil trading in the narrow-based index options and the ADR components of the index.

## IV. Conclusion

*It is therefore ordered,* pursuant to section 19(b)(2) of the Act,[28] that the proposed rule change, as amended, (File No. SR–ISE–2003–05) be, and it hereby is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[29]

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 03–22236 Filed 8–29–03; 8:45 am]

**BILLING CODE 8010–01–P**

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## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–48407; File No. SR–NASD–00–08]**

## Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1 and 2 by the National Association of Securities Dealers, Inc. Relating to Margin Requirements

August 25, 2003.

## I. Introduction

On March 3, 2000, the National Association of Securities Dealers, Inc. (''NASD'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 (''Exchange Act'')[1] and Rule 19b–4 thereunder,[2] a proposal to amend NASD Rule 2520, ''Margin Requirements.'' The NASD's proposal was published for comment in the **Federal Register** on May 26, 2000.[3] The Commission received one comment

[24] 17 CFR 240.11Aa3–1.

[25] ISG was formed on July 14, 1983, to, among other things, coordinate more effectively surveillance and investigative information sharing arrangements in the stock and options markets.

[26] *See* Securities Exchange Act Release No. 40761 (December 8, 1998), 63 FR 70952 (December 22, 1998) (File No. S7–13–98).

[27] *Id.*

[28] 15 U.S.C. 78s(b)(2).

[29] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 42801 (May 19, 2000), 65 FR 34240 (''2000 Release'').

letter regarding the proposal,[4] and the NASD responded to the comment.[5]

The NASD filed Amendment Nos. 1 and 2 to the proposal on June 2, 2000, and July 30, 2003, respectively. This order approves the proposed rule change, as amended. In addition, the Commission is publishing notice to solicit comments and is simultaneously approving, on an accelerated basis, Amendment Nos. 1 and 2.

## II. Description of the Proposal

### *A. Background*

Section 7 of the Exchange Act[6] authorizes the Board of Governors of the Federal Reserve System (''Federal Reserve Board'') to establish requirements for the purchase or carrying of securities on margin. Pursuant to this authority, the Federal Reserve Board promulgated Regulation T,[7] which sets minimum initial margin requirements. Regulation T provides that transactions in non-equity securities are subject to either ''good faith'' margin requirements[8] or the level set by the rules of a self-regulatory organization (''SRO''), whichever is higher.[9] Accordingly, the maintenance margin requirements established by the NASD or another SRO set the minimum margin levels for non-equity securities.[10]

As described more fully below, the proposal amends NASD Rule 2520 to: (1) lower the customer maintenance margin requirements for certain non-equity securities; and (2) permit good faith margin treatment for certain non-equity securities held in ''exempt accounts,'' as defined in the proposal.

### *B. Reduced Customer Maintenance Margin for Non-Equity Securities Not Held in Exempt Accounts*

With respect to non-equity securities that are not held in exempt accounts, the proposal: (1) Reduces the customer maintenance margin requirement for highly rated foreign sovereign debt[11] from 20% of current market value to 1% to 6% of current market value, depending on the time to maturity; (2) reduces the customer maintenance margin requirement for exempted securities other than U.S. government obligations from 15% of current market value to 7% of current market value; (3) reduces the customer maintenance margin requirement for investment grade non-equity securities[12] from 20% of current market value to 10% of current market value; and (4) establishes a customer maintenance margin requirement of 20% of current market value for all other marginable non-equity securities.[13]

### *C. Good Faith Margin Treatment for Certain Non-Equity Securities Held in Exempt Accounts*

1. Good Faith Margin Treatment

The proposal will permit broker-dealers to effect transactions in ''exempt accounts'' without being required to collect either margin or marked to the market losses[14] on exempted securities, mortgage-related securities,[15] or major foreign sovereign debt securities.[16] However, a broker-dealer must take a capital charge for any uncollected marked to the market losses on exempt account positions in these securities.[17]

For transactions in exempt accounts involving highly rated foreign sovereign debt[18] and investment grade debt,[19] the proposal establishes margin requirements of 0.5% and 3%, respectively.[20] Although a broker-dealer is not required to collect this margin, it must take a capital charge for any uncollected margin and for any uncollected marked to the market losses.[21]

2. Limitation on Capital Charges

The proposal limits the amount of capital charges a broker-dealer may take in lieu of collecting marked to the market losses.[22] Specifically, a broker-dealer may not enter into transactions with exempt accounts that would increase the broker-dealer's capital charges if the broker-dealer's capital charges exceed: (1) 5 % of the broker-dealer's tentative net capital[23] on any one account or group of commonly controlled accounts; or (2) 25% of the broker-dealer's tentative net capital on all accounts combined, unless the excess no longer exists on the fifth business day after it was incurred. The broker-dealer also must notify the NASD that it has reached the 5% or 25% threshold.

### *D. Amendment No. 1*

Under the proposal, a broker-dealer must maintain a written risk analysis methodology for managing the credit risk associated with extending good faith margin on securities transactions in ''exempt accounts.''[24] Amendment No. 1 provides a draft Notice to Members (''NTM'') that addresses the written risk analysis methodology that members must establish and maintain. Specifically, the NTM states that a member's written risk analysis methodology should include the following:

- Procedures for obtaining and reviewing the appropriate customer account documentation and the customer financial information necessary to determine exempt account status for the extension of credit under the Rule;
- Procedures and guidelines for the determination, review and approval of credit limits to customers and across all customers who qualify as exempt accounts under the Rule;
- Procedures and guidelines for monitoring credit risk exposure to the organization relating to exempt account customers;
- Procedures and guidelines for the use of stress testing of exempt accounts in order to monitor market risk exposure

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[4] *See* letter from Wendy Fried, Vice President and Associate General Counsel, The Bond Market Association (''TBMA''), to Jonathan Katz, Secretary, Commission, dated June 30, 2000 (''TBMA Letter'').

[5] *See* letter from Patrice M. Gliniecki, Vice President and Deputy General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated July 27, 2000 (''NASD Letter''). The TBMA Letter, and the NASD's response, are discussed below.

[6] 12 U.S.C. 78(g).

[7] 12 CFR 220 *et seq.*

[8] Regulation T defines ''good faith'' margin as the amount of margin that a broker-dealer would require in exercising sound credit judgment.

[9] 12 CFR 220.12(b).

[10] *See* NASD Rule 2520(c).

[11] The proposal defines ''highly rated foreign sovereign debt securities'' as debt securities issued or guaranteed by the government of a foreign country, its provinces, states or cities, or a supranational entity that are assigned a rating in one of the two top rating categories by at least one nationally recognized statistical rating organization. *See* NASD Rule 2520(a)(9).

[12] The proposal defines ''investment grade debt'' as any debt securities assigned a rating in one of the top four rating categories by at least one nationally recognized statistical rating organization. *See* NASD Rule 2520(a)(10).

[13] The proposal defines ''other marginable non-equity securities'' to include debt securities not traded on a national securities exchange that meet certain requirements and private pass-through securities not guaranteed by a U.S. government agency that meet certain requirements. *See* NASD Rule 2520(a)(16).

[14] Marked to the market losses are unrealized losses on a position in securities resulting from a decline in the position's market value.

[15] The proposal defines ''mortgage related securities'' to mean securities that fall within the definition in Section 3(a)(41) of the Exchange Act. *See* NASD Rule 2520(a)(12).

[16] The proposal defines ''major foreign sovereign debt securities'' as debt securities issued or guaranteed by the government of a foreign country or supranational entity that are assigned a rating in the top rating category by at least one nationally recognized statistical rating organization. *See* NASD Rule 2520(a)(11).

[17] *See* NASD Rule 2520(e)(2)(F).

[18] *See* note 11, *supra*.

[19] *See* note 12, *supra*.

[20] *See* NASD Rule 2520(e)(2)(G).

[21] *See* NASD Rule 2520(e)(2)(G).

[22] *See* NASD Rule 2520(e)(2)(H).

[23] Generally, tentative net capital is a broker-dealer's net worth after deducting most illiquid assets but before making haircut deductions.

[24] *See* NASD Rule 2520(e)(2)(H)(i).

from exempt accounts individually and in the aggregate; and

• Procedures providing for the regular review and testing of these risk management procedures by an independent unit such as internal audit, risk management, or other comparable group.

*E. Amendment No. 2*

Amendment No. 2 revises the proposal by modifying the definition of ''exempt account'' in proposed NASD Rule 2520(a)(13). The proposed changes to proposed NASD Rule 2520(a)(13), as published in the 2000 Release,[25] appear below. Proposed additions are in *italics*; proposed deletions are in [brackets].

**2520. Margin Requirements**

(a) Definitions

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

(1) through (12). No change.

(13) The term ''exempt account'' means*:* [a member, non-member broker/dealer registered as a broker or dealer under the Act, ''designated account,'' or any person having net worth of at least forty-five million dollars and financial assets of at least forty million dollars.]

*(A) a member, non-member broker/dealer registered as a broker or dealer under the Act, a ''designated account,'' or*

*(B) any person that:*

*(i) has a net worth of at least forty-five million dollars and financial assets of at least forty million dollars for purposes of subparagraphs (e)(2)(F) and (e)(2)(G), and*

*(ii) either:*

*a. has securities registered pursuant to Section 12 of the Act, has been subject to the reporting requirements of Section 13 of the Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or*

*b. has securities registered pursuant to the Securities Act of 1933, has been subject to the reporting requirements of Section 15(d) of the Act for a period of at least 90 days and has filed all the reports required to be filed thereunder during the preceding 12 months (or such shorter period as it was required to file such reports), or*

*c. if such person is not subject to Section 13 or 15(d) of the Act, it is a person with respect to which there is publicly available the information specified in paragraphs (a)(5)(i) to (xiv), inclusive, of Rule 15c2–11 under the Act, or*

*d. furnishes information to the Securities and Exchange Commission as required by Rule 12g3–2(b) of the Act, or*

*e. makes available to the member such current information regarding such person's ownership, business, operations and financial condition (including such person's current audited statement of financial condition, statement of income and statement of changes in stockholder's equity or comparable financial reports), as reasonably believed by the member to be accurate, sufficient for the purposes of performing a risk analysis in respect of such person.*

**III. Summary of Comments**

The Commission received one comment letter regarding the proposal.[26] The commenter generally supported the proposal, which is substantially identical to a proposal by the New York Stock Exchange, Inc. (''NYSE'') that the Commission approved.[27] However, the commenter maintained that the written risk analysis methodology included in the NASD's proposal was not required under the NYSE's proposal and was unnecessary because NASD members already are subject to sophisticated external and internal oversight of credit practices. The NASD responded by noting that the written risk analysis methodology was in fact proposed to be required by the NYSE.[28]

In addition, the commenter referenced its comment letter regarding the NYSE's similar proposal.[29] Specifically, the commenter requested clarification that: (1) the NYSE's proposed definition of ''exempt account'' would not supersede the existing definition of ''exempt account'' in NYSE Rule 431(f)(2)(D)(iv); and (2) existing extensions of credit to accounts that met the current requirements for exempt account status, but that would not meet the proposal's higher financial threshold for exempt accounts, would be ''grandfathered'' and maintained based on exempt account status even after the increased financial threshold became effective. In this regard, the NASD confirmed that the proposal's definition of ''exempt account'' does not replace the current definition of ''exempt account'' contained in NASD Rule 2520(f)(2)(D)(iv). With respect to an extension of credit to an account that currently qualifies as exempt but that would not qualify as an exempt account under the proposal, the NASD indicates that an account's exempt status will be determined as of the date of the initial extension of credit. Accordingly, accounts that meet the current requirements for exempt account status would be ''grandfathered'' on their existing credit transactions, and the proposal's requirements for exempt account status would apply to any new credit transactions or ''roll-overs'' of existing credit extensions.

**IV. Discussion**

Section 15A(g)(3)(A) of the Exchange Act[30] provides, among other things, that a national securities association may condition membership privileges on compliance with the association's own financial responsibility rules. Pursuant to this authority, the NASD is authorized to promulgate rules governing the financial responsibility requirements of its members. In addition, the Commission finds that the proposed rule change is consistent with the Exchange Act and the rules and regulations thereunder applicable to a national securities association.[31] In particular, as described above, for positions not maintained in exempt accounts, the proposal reduces the customer maintenance margin requirement for certain non-equity securities and establishes a customer maintenance margin requirement of 20% of current market value for other marginable non-equity securities. The Commission believes that these

[25] *See* note 3, *supra.*

[26] *See* TBMA Letter, *supra* note 4.

[27] *See* Securities Exchange Act Release No. 48365 (August 19, 2003) (order approving File No. SR–NYSE–98–14) (''NYSE Order''). *See also* Securities Exchange Act Release Nos. 40278 (July 29, 1998), 63 FR 41822 (August 5, 1998) (notice of File No. SR–NYSE–98–14); and 48133 (July 7, 2003), 68 FR 41672 (July 14, 2003) (notice of Amendment Nos. 1, 2, and 3 to File No. SR–NYSE–98–14) (''2003 Release'').

[28] *See* NASD Letter, *supra* note 5. The NYSE proposed the requirement that members maintain a written risk analysis methodology in Amendment No. 1 to its proposal, which was filed on January 5, 1999, and published for comment on July 14, 2003. The NYSE subsequently filed an Information Memo providing guidelines for a member's written risk analysis methodology. Amendment No. 1 to the NASD's proposal, set forth in Section II.D., *supra,* contains an NTM with written risk analysis methodology guidelines identical to the guidelines established in the NYSE's Information Memo.

[29] *See* letter from Paul Saltzman, Senior Vice President and General Counsel, TBMA, and Patricia Brigantic, Vice President and Senior Associate General Counsel, TBMA, to Jonathan Katz, Secretary, Commission, dated August 26, 1998 (''TBMA 1998 Letter''). The TBMA 1998 Letter, and the NYSE's response, are discussed in the 2003 Release, *supra* note 27. As noted in the NYSE Order, *supra* note 27, the Commission believes that the NYSE sufficiently addressed the questions raised in the TBMA 1998 Letter.

[30] 15 U.S.C. 78o–3(g)(3)(A).

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

requirements are consistent with the risks of those securities.

The proposal also permits the extension of good faith margin to certain non-equity securities held in exempt accounts. The Commission notes that the definition of exempt account is limited to certain regulated entities as well as to persons with net worth of at least $40 million and financial assets of at least $45 million about whom certain information is publicly available or who make available to the broker-dealer certain current financial information. The Commission believes that these requirements are important to the broker-dealer's evaluation of the creditworthiness of the exempt account borrower and its ability to make an informed decision regarding an extension of good faith margin to the exempt account.

The Commission also notes that the proposal limits the amount of capital charges a broker-dealer may take in lieu of collecting marked to the market losses. Specifically, a broker-dealer may not enter into transactions with exempt accounts that would increase the broker-dealer's capital charges if the broker-dealer's capital charges exceed: (1) 5% of the broker-dealer's tentative net capital on any one account or group of commonly controlled accounts; or (2) 25% of the broker-dealer's tentative net capital on all accounts combined, unless the excess no longer exists on the fifth business day after it was incurred. In addition, the proposal requires broker-dealers to maintain a written risk analysis methodology for assessing the amount of good faith credit extended to exempt accounts and assures that a broker-dealer has procedures for determining, approving, and monitoring extensions of credit to exempt accounts. The Commission believes that these requirements establish important safeguards to minimize potential risks to a broker-dealer.

Accordingly, the Commission finds that the proposed rule change is consistent with section 15A(b)(6) of the Exchange Act,[32] which requires, among other things, that the rules of a national securities association be designed to promote just and equitable principles of trade, and to protect investors and the public interest.

The Commission finds good cause for approving Amendment Nos. 1 and 2 to the proposal prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. Amendment Nos. 1 and 2 strengthen the proposal by providing guidelines for the written risk analysis methodology that NASD members must develop and maintain, and by requiring a person seeking exempt account status to meet specific registration and reporting requirements, or to provide certain current information concerning the person's ownership, business, operations, and financial condition. In addition, Amendment Nos. 1 and 2 conform the NASD's proposal to an NYSE proposal that the Commission approved previously.[33] Accordingly, the Commission finds that there is good cause, consistent with sections 15A(b)(6) and 19(b) of the Exchange Act, to approve Amendment Nos. 1 and 2 on an accelerated basis.

## V. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 1 and 2, including whether Amendment Nos. 1 and 2 are consistent with the Exchange 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 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 NASD. All submissions should refer to file number SR–NASD–00–08 and should be submitted by September 23, 2003.

## VI. Conclusion

*It is therefore ordered,* pursuant to section 19(b)(2) of the Exchange Act,[34] that the proposed rule change (SR–NASD–00–08), as amended, is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[35]

**Margaret H. McFarland,**

*Deputy Secretary.*

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[32] 15 U.S.C. 78o-3(b)(6).

[33] *See* NYSE Order, *supra* note 27.

[34] 15 U.S.C. 78s(b)(2).

[35] 17 CFR 200.30–3(a)(12).

## SECURITIES AND EXCHANGE COMMISSION

**[Release No. 34–48395; File No. SR–NASD–2003–124]**

## Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the National Association of Securities Dealers, Inc. To Institute an Hourly Maintenance Fee Associated With the Use of the Nasdaq Workstation II Service by Persons That Are Not NASD Members

August 22, 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 August 6, 2003, 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'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by Nasdaq.[3] Nasdaq has designated the proposed rule change as constituting a ''non-controversial'' rule change under section 19(b)(3)(A)(iii) of the Act,[4] and paragraph (f)(6) of Rule 19b-4 under the Act,[5] which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

Nasdaq proposes to institute an hourly fee for maintenance services supplied for equipment used in connection with the Nasdaq Workstation™ II (''NWII'') service.[6] Nasdaq proposes to implement the proposed rule change thirty days after August 6, 2003.[7]

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

[3] On August 12, 2003, Nasdaq filed an amendment to the proposed rule change, which it subsequently withdrew. Telephone conversation between John M. Yetter, Associate General Counsel, Nasdaq, and Frank N. Genco, Division of Market Regulation (''Division''), Commission, on August 19, 2003.

[4] 15 U.S.C. 78s(b)(3)(A).

[5] 17 CFR 240.19b-4(f)(6).

[6] This filing applies to persons that are not NASD members. On August 6, 2003, Nasdaq also submitted a proposed rule change to implement an identical charge for NASD members. *See* File No. SR–NASD–2003–123.

[7] In this filing, Nasdaq is also moving the text of the footnote to NASD Rule 7010(f) into the text of