

44) is hereby approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>16</sup>

J. Lynn Taylor,

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45311; File No. SR-ISE-2001-26]

### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval to Proposed Rule Change by International Securities Exchange LLC To Increase Position and Exercise Limits for Nasdaq-100 Index Tracking Stock Options

January 18, 2002.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934,<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 8, 2001, the International Securities Exchange LLC ("ISE" or "Exchange") filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. On January 16, 2002, the Exchange filed Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change, as amended.

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

The ISE proposes to increase position and exercise limits for Nasdaq-100 Index Tracking Stock ("QQQ") options to 300,000 contracts on the same side of the market. The text of the proposed rule change is available at the Office of the Secretary, ISE, and at the Commission.

#### 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 ISE 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 III below. The ISE has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

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

###### 1. Purpose

The Exchange is proposing to increase position and exercise limits for options on the Nasdaq 100 Index Tracking Stock ("QQQ options") up to 300,000 contracts on the same side of the market. As discussed below, the Exchange believes that the current limits for non-flex equity options are no longer appropriate for QQQ options given the liquidity of the options, the underlying security, and the securities that comprise the Nasdaq-100 Index.

QQQ options are popular hedging instruments in today's market and by far the most active listed option product. The average daily trading volume for QQQ options was 243,763 contracts during the first quarter of 2001, 330,786 contracts during the second quarter, and 316,425 contracts during the third quarter. As of October 2001, the average daily trading volume of QQQ options is 298,858 contracts.<sup>4</sup>

One of the primary purposes for imposing position and exercise limits is to minimize the opportunity for manipulation, which is an attempt to influence the price movement of an underlying stock to benefit a previously established options position.<sup>5</sup> The

<sup>4</sup> The ISE notes that in comparison, the Commission approved the total elimination of position limits for options traded on the SPX, OEX and DJX, all of which are broadbased indexes traded solely on the Chicago Board of Options Exchange ("CBOE"). Year to date the average daily trading volume of options on these three indexes is 92,814 contracts, 43,544 contracts, and 35,365 contracts respectively. Thus, daily average volume in QQQ options is more than 3.2 times that of the SPX and nearly 8.5 times that of the DJX. See Securities Exchange Act Release No. 41011 (Feb. 1, 1999) (Order approving elimination of position and exercise limits for XMI and XII options on a two-year pilot basis); and Securities Exchange Act Release No. 40969 (Feb. 1, 1999) (Order approving the elimination of position and exercise limits for SPX, OEX, DJX on a two-year pilot basis).

<sup>5</sup> See Securities Exchange Act Release No. 39489 (Dec. 24, 1997), 63 FR 276 (Jan. 5, 1998)

Nasdaq 100 Index Tracking Stock represents ownership in a long-term unit investment trust that holds a portfolio of the equity securities that track and Nasdaq-100 Index. Thus, while QQQ options are not technically index options (for which the Commission has previously approved the elimination of position limits for options on certain enormously capitalized indexes),<sup>6</sup> the ISE believes that they are economically similar and are used by investors in the same manner and with the same investment objectives as index options.<sup>7</sup> The Nasdaq-100 Index includes 100 of the largest non-financial companies listed on Nasdaq, each of which has an average daily trading volume of at least 100,000 shares and a market capitalization of at least \$500 million.<sup>8</sup> The Exchange believes that it would be extremely difficult for an investor to influence the price of the Nasdaq-100 Index in order to benefit a previously established options position.

The reporting requirements in ISE Rule 415(b) will continue to apply to QQQ options.<sup>9</sup> Rule 415(b) requires Electronic Access Members to report end of day positions in all non-FLEX equity options in excess of 10,000 contracts on the same side of the market. The report must specify whether such position is hedged and provide documentation as to how such position is hedged, including a description of any collateral used to carry the position. This report is required at the time the account exceeds the 10,000 contract threshold and thereafter, for customer accounts, when

<sup>6</sup> See *supra* note 4.

<sup>7</sup> The Commission notes that the elimination of position and exercise limits for certain broad-based index options was based on many factors including the enormous capitalizations of the indexes. For example, the market capitalization of the SPX, OEX and DJX as of October 2001 was \$9.81 trillion, \$5.7 trillion and \$3.23 trillion, respectively. See Securities Exchange Act Release No. 44994 (October 26, 2001), 66 FR 55722 (November 2, 2001) (permanently approving the pilot to eliminate position and exercise limits for OEX, SPX and DJX Index options). In contrast, the market capitalization of the NASDAQ 100 as of November 2001 was 1.875 trillion. The Commission further notes that options on QQQs physically settle in the underlying QQQs, which had net assets of \$23.96 billion as of November 30, 2001. In contrast, index options are cash settled based on the underlying value of the index.

<sup>8</sup> According to information available on Bloomberg, L.P., an information company, the average daily trading volume for the Nasdaq 100 Index Tracking Stock was 66.8 million shares during the first quarter of this year, 69.8 million shares during second quarter, and 64.6 million during the third quarter.

<sup>9</sup> The general reporting requirement contained in ISE Rule 415(a) for customer accounts that maintain a position in excess of 200 contracts also will remain applicable for QQQ options.

<sup>16</sup> 17 CFR 200.30-3(a)(12).

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

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

<sup>3</sup> Amendment No. 1 supercedes and replaces the original 19b-4 filing in its entirety.

the position increases by 2,500 contracts and for proprietary accounts, when the position increases by 5,000. Exchange market-makers are not required to report under ISE Rule 415(b) as market-makers account positions can be accessed through the Exchange's market surveillance systems.

Finally, the Exchange proposes to explicitly state in Supplementary Material to ISE Rule 412 that it may use its authority under ISE Rule 1204(b) to impose additional margin requirements upon an account that maintains under-hedged options positions.

## 2. Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act<sup>10</sup> in general and furthers the objectives of section 6(b)(5)<sup>11</sup> in particular in that it is 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 facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, to protect investors and the public interest and is not designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

### *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.

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

No written comments were solicited or received with respect to the proposed rule change.

## III. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities 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 Section. Copies of such filing will also be available for inspection and copying at the principal office of the ISE. All submissions should refer File No. SR-ISE-2001-26 and should be submitted by February 15, 2002.

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

After careful review, 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. In particular, the Commission believes the proposal is consistent with the requirements of section 6(b)(5) of the Act<sup>12</sup> in that it is designed to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, and to remove impediments to and perfect the mechanism of a free and open market and a national market system.

Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In the past, the Commission has stated that:

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.<sup>13</sup>

In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. The Commission has been careful to balance two competing

concerns when considering the appropriate level at which to set position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market in the component securities comprising the indexes. At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs or to prevent specialists and market makers from adequately meeting their obligations to maintain a fair and orderly market.<sup>14</sup>

The Commission has carefully considered the ISE's proposal to increase position and exercise limits for QQQ options. At the outset, the Commission notes that it still believes the fundamental purpose of position and exercise limits are being served by their existence. However, given the surveillance capabilities of the Exchange and the depth and liquidity in both the QQQ options and the underlying cash market in QQQs, the Commission believes it is permissible to significantly raise position limits for QQQ options without risk of disruption to the options or underlying cash markets. Specifically, the Commission believes that it is appropriate to increase position and exercise limits from 75,000 contracts to 300,000 contracts for QQQ options for several reasons.

First, the Commission believes that the structure of the QQQ options and the considerable liquidity of both the underlying cash and options market for QQQ options lessens the opportunity for manipulation of this product and disruption in the underlying product that a lower position limit may protect against. In this regard, the ISE notes that the average daily trading volume for QQQ options was 243,763 contracts during the third quarter of 2001, 330,786 contracts during the second quarter, and 316,425 contracts during the third quarter. The ISE also notes that the QQQ option is the most actively-traded option in the U.S. markets, and the underlying QQQ is the most actively-traded equity security in the U.S. markets.<sup>15</sup> These factors provide support for higher limits for the QQQ options and differentiate them from other equity options.

Second, the Commission notes that current margin and risk-based haircut

<sup>14</sup> *Id.*

<sup>15</sup> As noted by the ISE, the QQQ is designed to closely track the performance of the Nasdaq-100 Index. As of November 30, 2001, the market capitalization of the securities underlying the Nasdaq-100 Index was \$1.875 trillion.

<sup>10</sup> 15 U.S.C. 78f(b).

<sup>11</sup> 15 U.S.C. 78f(b)(5).

<sup>12</sup> 15 U.S.C. 78f(b)(5). In approving this rule change, the Commission notes that it has considered the proposal's impact on efficiency, competition, and capital formation, consistent with Section 3 of the Act. *Id.* at 78c(f).

<sup>13</sup> See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998).

methodologies serve to limit the size of positions maintained by any one account by increasing the margin and/or capital that a member must maintain for a large position held by itself or by its customer. In this regard, the Commission believes the ISE's adoption of Supplementary Material to ISE Rule 412, to state that the ISE has the authority to impose additional margin on options positions if it determines that this is warranted, is appropriate.

Finally, the Commission believes that the reporting requirements imposed by the Exchange under ISE Rule 415(b), which will continue to require that each member or member organization that maintains a position on the same side of the market in excess of 10,000 contracts in the QQQ option, for its own account or for the account of a customer report certain information, will help protect against potential manipulation. The Exchange also requires members to report subsequent incremental increases in positions, thus assuring that positions are regularly monitored by the Exchange. In particular, information that must be reported includes, among other things, whether or not the options position is hedged, and if so, a description of the hedge. The information should help the ISE to monitor accounts and determine whether it is necessary to impose additional margin for under-hedged positions, as provided under its rules. The Commission believes that these financial requirements are sufficient to address concerns that a member or its customer may try to maintain an inordinately large unhedged position in QQQ options.

In summary, the financial and reporting requirements noted above should allow the Exchange to detect and deter trading abuses arising from the increased position and exercise limits, and will also allow the Exchange to monitor large positions in order to identify instances of potential risk and to assess additional margin and/or capital charges, if deemed necessary. These requirements coupled with the special trading characteristics of the QQQ options and the underlying QQQs noted above, warrant approval of the Exchange's proposal.<sup>16</sup>

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of the notice of filing

<sup>16</sup> Of course, the Commission expects that ISE will take prompt action, including timely communication with the Commission and other marketplace self-regulatory organizations responsible for oversight of trading in the underlying QQQ, should any unanticipated adverse market effects develop due to the increased limits.

thereof in the **Federal Register**. The Commission notes that under the current Exchange rules, the position and exercise limits applicable to QQQ options is 75,000 contracts. However, due to a 50% reduction in the value of the underlying QQQ on March 20, 2000, the limit was adjusted to 150,000 contracts. The position and exercise limits are scheduled to revert back to 75,000 contracts after the January options expiration occurring on January 18, 2002. The Commission notes that limits of 75,000 contracts for the QQQ options could reduce depth and liquidity in the QQQ market. The Commission believes for the reasons noted above that it is appropriate to approve this proposed rule change increasing the position and exercise limit to 300,000 contracts on January 18, 2002. Accordingly, the Commission finds that there is good cause, consistent with section 6(b)(5) of the Act,<sup>17</sup> to approve the proposal on an accelerated basis.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act,<sup>18</sup> that the proposed rule change (SR-ISE-2001-26) is hereby approved, as amended, on an accelerated basis.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

**J. Lynn Taylor,**

*Assistant Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45299; File No. SR-MBSCC-2001-02]

### Self-Regulatory Organizations; MBS Clearing Corporation; Notice of Filing of a Proposed Rule Change Implementing a Real-Time Trade Matching Service

January 17, 2002.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on September 19, 2001, MBS Clearing Corporation ("MBSCC") filed with the Securities and Exchange Commission ("Commission") and on September 26, 2001, amended the proposed rule change as described in Items I, II, and III below, which Items have been prepared primarily by MBSCC. The Commission is publishing this notice to

<sup>17</sup> 15 U.S.C. 78f(b)(5).

<sup>18</sup> 15 U.S.C. 78s(b)(2).

<sup>19</sup> 17 CFR 200.30-3(a)(12)

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

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

The proposed rule change will implement a real-time trade matching service.

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

In its filing with the Commission, MBSCC 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. MBSCC has prepared summaries, set forth in sections (A), (B) and (C) below, of the most significant aspects of such statements.<sup>2</sup>

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

In furtherance of MBSCC's mission to reduce the costs and risks associated with trading in the mortgage-backed securities market, MBSCC has enhanced its services to enable its participants to submit executed trade terms and to receive comparison results from MBSCC in a more timely manner. The cornerstone of this objective is the implementation of the Real-Time Trade Matching ("RTTM") service that will replace MBSCC's current twice-daily match process with respect to trade input information. MBSCC anticipates that the RTTM service will provide more certainty, will reduce execution/market risk, and will eliminate the redundancy between the verbal checkout process (which is described below) and the current MBSCC matching process.<sup>3</sup>

MBSCC's objective in implementing the RTTM service is to match all trade input in real-time within minutes of trade execution while providing participants with the greatest flexibility and least amount of disruption in the

<sup>2</sup> The Commission has modified parts of these statements.

<sup>3</sup> One of the main objectives of the RTTM service is to significantly reduce the risks associated with a prolonged period of time between trade execution and achievement of legal and binding confirmation. The elapsed time between trade execution and verbal checkout, followed by a legal and binding confirmation, is a known and serious risk to the ultimate settlement of the trade for all trading organizations. Reducing the elapsed time between trade execution and achievement of a legal and binding confirmation increases certainty and reduces risk.