

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46228; File No. SR-ISE-2002-15]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the International Stock Exchange, Inc. To Eliminate Position and Exercise Limits for Certain Qualified Hedge Strategies

July 18, 2002.

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 June 26, 2002, the International Stock Exchange, Inc. (“ISE” or “Exchange”) filed with the Securities and Exchange Commission (“SEC” or “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.

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

The Exchange is proposing to amend ISE Rule 413 to eliminate position and exercise limits when certain qualified hedge strategies are employed to establish a hedged equity option position and to establish a position and exercise limit of five times the standard limit for those strategies that include an OTC option contract. The current reporting procedures that serve to identify and document hedged positions will continue to apply. The text of the proposed rule change is available at the Office of the Secretary, the Exchange, 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 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. The Exchange 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 eliminate position and exercise limits when certain qualified strategies are employed to establish a hedged equity option position and to establish a position and exercise limit of five times the standard limit for those strategies that include an OTC option contract. Current ISE Rule 413 provides position and exercise limits for stock options of 13,500, 22,500, 31,500, 60,000 and 75,000 options contracts on the same side of the market depending on the level of underlying trading volume over a six-month period. The existing hedge exemption provides an exemption to position and exercise limits of up to three (3) times the standard limit for certain qualified hedge strategies as follows: (i) Long call and short stock; (ii) short call and long stock; (iii) long put and long stock; and (iv) short put and short stock.

The ISE represents that the types of hedge strategies employed by market participants are becoming increasingly more diversified. The Exchange believes that, through its experience in administering and processing equity hedge exemption information, it has learned that market participants no longer rely strictly on a stock-option hedge. Additionally, while traditional hedge strategies such as a covered call or reverse conversion strategy continue to be utilized, the ISE believes that listed options contracts are now employed to hedge a wider spectrum of securities.

In response to the Commission’s liberalization in granting position limit relief for market neutral strategies, and to more fully accommodate the hedging needs of investors, the Exchange is proposing to eliminate position and exercise limits when certain qualified strategies are employed to establish a hedged equity options position. Accordingly, the ISE proposes to expand the definition of a “qualified” hedged position found in ISE Rule 413. The proposed qualified hedged strategies are as follows:

1. Where each option contract is “hedged” by the number of shares underlying the option contract or securities convertible into the underlying security or, in the case of an adjusted option, the same number of shares represented by the adjusted contract: (a) Long call and short stock; (b) short call and long stock; (c) long put

and long stock; or (d) short put and short stock.

2. *Reverse Conversions*—A long call position accompanied by a short put position, where the long call expires with the short put and the strike price of the long call and short put is the same, and where each long call and short put contract is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.³

3. *Conversions*—A short call position accompanied by a long put position, where the short call expires with the long put and the strike price of the short call and long put is the same, and where each short call and long put contract is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.⁴

4. *Collars*—A short call position accompanied by a long put position, where the short call expires at the same time as the long put and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position, is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the short call/long put position can be in-the-money at the time the position is established.⁵

5. *Box Spreads*—A long call position accompanied by a short put position, where both the long call and short put have the same strike price, and a short call position accompanied by a long put position, where the short call and long put have the same strike price as each other, but a different strike price than the long call/short put position.

6. *Back-to-Back Options*—A listed option position hedged on a one-for-one basis with an over-the-counter (“OTC”) option position on the same underlying security. The strike price of the listed option position and corresponding OTC option position must be within one strike price interval of each other and no more than one expiration month apart.

³ For reverse conversion, conversion, and collar strategies, one of the option components can be an OTC option guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account. Hedge transactions and positions established pursuant to these strategies are subject to a position limit equal to five times the standards limit established under ISE Rule 412(c) and Supplementary Material .02 to Rule 412. For purposes of this rule filing, an OTC option contract is defined as an option that is not listed on a National Securities Exchange or cleared at the Options Clearing Corporation.

⁴ *Id.*

⁵ *Id.*

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

Within the list of proposed hedge strategies eligible for the Equity Hedge Exemption, the Exchange proposes that the option component of a reversal, a conversion or a collar position can be treated as one contract rather than as two (2) contracts. All three strategies serve to hedge a related stock portfolio. Because these strategies require the contemporaneous⁶ purchase/sale of both a call and put component, against the appropriate number of shares underlying the option (generally 100 shares) the Exchange believes that the position should be treated as one contract for hedging purposes.

Under the proposed rule change, the standard position and exercise limits will remain in place for unhedged equity option positions. Once an account nears or reaches the standard limit, positions identified as a qualified hedge strategy will be exempted from position limit calculations. The exemption will be automatic (*i.e.*, does not require pre-approval from the Exchange) to the extent that the member identifies that a pre-existing qualified hedge strategy is in place or is employed from the point that an account's position reaches the standard limit and provides the required supporting documentation to the Exchange.

The exemption will remain in effect to the extent that the exempt positions remain intact and the Exchange is provided with any required supporting documentation. Procedures to demonstrate that the option position remains qualified are similar to those currently in place. Exchange procedures currently require a qualified account to report hedge information each time the option position changes. Hedge information for member firm and customer accounts are electronically reported via the Large Options Positions Report. Market maker account information is also reported to the Exchange electronically by the member's clearing firm. The existing requirement imposed on a member firm to report hedge information for proprietary and customer accounts that maintain an options position in excess of 10,000 contracts will continue to apply.

The ISE believes that, with the exception of covered stock positions, all of the proposed qualified hedge strategies are market neutral.⁷ Therefore,

⁶ At or about the same time.

⁷ Where covered stock transactions are not market neutral (*i.e.*, long stock/short call; short stock/short put); the market exposure on such activity resides with the stock position where no limit is imposed. The ISE believes that, as the short option premium serves to mitigate the stock exposure, no limit should be imposed on this strategy.

none of the proposed strategies lend themselves to market manipulation and should be exempt from position limits. In addition, the Exchange believes that the current reporting requirements under ISE rules and the surveillance procedures for hedged positions will enable the Exchange to closely monitor sizable option positions and corresponding hedges.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with section 6(b) of the Act⁸ in general and furthers the objectives of section 6(b)(5)⁹ 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

The Exchange has neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective pursuant to section 19(b)(3)(A) of the Act¹⁰ and Rule 19b-4(f)(6)¹¹ thereunder because the proposal: (i) Does not significantly affect the protection of investors or the public interest; (ii) does not impose any significant burden on competition; and (iii) does not become operative prior to 30 days after the date of filing or such shorter time as the Commission may designate if consistent with the protection of investors and the public interest; provided that the Exchange has given the Commission notice of its intent to file the proposed rule change,

⁸ 15 U.S.C. 78f(b).

⁹ 15 U.S.C. 78f(b)(5).

¹⁰ 15 U.S.C. 78s(b)(3)(A).

¹¹ 17 CFR 240.19b-4(f)(6).

along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such short time as designated by the Commission. At any time within 60 days of the filing of such proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Act.

The ISE has requested that the Commission waive the 30-day operative delay. The Commission believes waiving the 30-day operative delay is consistent with the protection of investors and the public interest. The Commission notes that the proposal is substantially identical to proposed rule changes submitted by other options exchanges, which the Commission has approved.¹² The Commission also notes that these proposals were noticed for public comment and no comment was received. The Commission does not believe that the proposed rule change raises novel regulatory issues that were not already addressed in the approval orders to these proposed rule changes.¹³ For these reasons, the Commission designates the proposal to be effective and operative as of the date of this order.¹⁴

IV. 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 Commission and any person, other than those that may be withheld from the

¹² See Securities Exchange Act Release No. 45737 (April 11, 2002), 67 FR 18975 (April 17, 2002) (SR-PCX-00-45); Securities Exchange Act Release No. 45650 (March 26, 2002), 67 FR 15638 (April 2, 2002) (SR-Amex-2001-72); Securities Exchange Act Release No. 44503 (March 20, 2002), 67 FR 14751 (March 27, 2002) (SR-CBOE-00-12).

¹³ *Id.*

¹⁴ For purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-ISE-2002-15 and should be submitted by August 15, 2002.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁵

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 02-18839 Filed 7-24-02; 8:45 am]

BILLING CODE 8010-01-P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46232; File No. SR-NASD-2002-94]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc. to Reinstate a Transaction Credit Pilot Program for Exchange-Listed Securities

July 19, 2002.

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 July 8, 2002, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), 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. On July 17, 2002, Nasdaq amended the proposal.³ Nasdaq filed the proposal pursuant to section 19(b)(3)(A) of the Act,⁴ and Rule 19b-4(f)(6) thereunder,⁵ which renders the proposal effective

¹⁵ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See July 17, 2002 letter from Mary M. Dunbar, Vice President and Deputy General Counsel, Nasdaq, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission and attachments ("Amendment No. 1"). In Amendment No. 1, Nasdaq provided clarification as to the procedural history of its transaction credit pilot program, and in particular, with regard to SR-NASD-2002-68. For purposes of calculating the 60-day abrogation period, the Commission considers the period to have commenced on July 17, 2002, the date Nasdaq filed Amendment No. 1.

⁴ 15 U.S.C. 78s(b)(3)(A).

⁵ 17 CFR 240.19b-4(f)(6).

upon filing with the Commission.⁶ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

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

As of July 1, 2002, Nasdaq proposes to reinstate its transaction credit pilot program for exchange-listed securities for a six-month pilot period, through December 31, 2002. The text of the proposed rule change is below. Proposed new language is in italics; proposed deletions are in brackets.⁷

7010. System Services

(a)-(b) No change.

(c)(1) No change.

(2) Exchange-Listed Securities

Transaction Credit.

For a pilot period, qualified NASD members that trade securities listed on the NYSE and Amex in over-the-counter transactions reported by the NASD to the Consolidated Tape Association may receive from the NASD transaction credits based on the number of trades so reported. To qualify for the credit with respect to Tape A reports, an NASD member must account for 500 or more average daily Tape A reports of over-the-counter transactions as reported to the Consolidated Tape during the concurrent calendar quarter. To qualify for the credit with respect to Tape B reports, an NASD member must account for 500 or more average daily Tape B reports of over-the-counter transactions as reported to the Consolidated Tape during the concurrent calendar quarter. If an NASD member is so qualified to earn credits based either on its Tape A activity, or its Tape B activity, or both, that member may earn credits from one or both pools maintained by the NASD, each pool representing 40% of the revenue paid by the Consolidated Tape Association to the NASD for each of Tape A and Tape B transactions. A

⁶ Nasdaq asked the Commission to waive the 5-day pre-filing notice requirement and the 30-day operative delay. See Rule 19b-4(f)(6)(iii). 17 CFR 240.19b-4(f)(6)(iii).

⁷ On July 2, 2002, the Commission abrogated SR-NASD-2002-68. See Securities Exchange Act Release No. 46159 (July 2, 2002), 67 FR 45775 (SR-NASD-2002-61, SR-NASD-2002-68, SR-CSE-2002-06, and SR-PCX-2002-37) (order of summary abrogation). By abrogating SR-NASD-2002-68, the Commission eliminated the pilot program, despite the fact that the NASD Rules still contained NASD Rule 7010(c)(2). Because Nasdaq is reinstating the pilot program at this time, the Commission did not require Nasdaq to file a proposed rule change to eliminate the language of NASD Rule 7010(c)(2). As a result, the only language that appears in italics as new language is the language identifying the expiration date of the newly reinstated pilot program.

qualified NASD member may earn credits from the pools according to the member's pro rata share of the NASD's over-the-counter trade reports in each of Tape A and Tape B for each calendar quarter starting with July 1, 2000 for Tape A reports (April 1, 2000 for Tape B reports) and ending with the calendar quarter starting on [April] *October 1, 2002.*

(d)-(r) No change.

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

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for its proposal and discussed any comments it received regarding the proposal. The text of these statements may be examined at the places specified in Item IV below. Nasdaq 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

Nasdaq proposes to reinstate through December 31, 2002 its pilot program to provide a transaction credit to NASD members that exceed certain levels of trading activity in exchange-listed securities. Nasdaq's InterMarket is a quotation, communication, and execution system that allows NASD members to trade stocks listed on the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex").⁸ The InterMarket competes with regional exchanges like the Chicago Stock Exchange ("CHX") and the Cincinnati Stock Exchange ("CSE") for retail order flow in stocks listed on the NYSE and the Amex. The NASD collects trade reports from broker-dealers trading these securities in the over-the-counter ("OTC") market and provides the trade reports to the Consolidated Tape Association ("CTA") for inclusion in the Consolidated Tape. As a participant in the CTA Plan, the NASD is entitled to a portion of the revenue that the CTA generates by selling this market data information. NASD's share of the revenues is based on trades that it reports on behalf of these broker-dealers in NYSE-listed

⁸ Nasdaq's InterMarket formerly was referred to as Nasdaq's Third Market. See Securities Exchange Act Release No. 42907 (June 7, 2000); 65 FR 37445 (June 14, 2002) (SR-NASD-00-323).