

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-46548; File No. SR-NQLX-2002-01]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Nasdaq Liffe Markets, LLC Relating to Margin Rules for Security Futures Products Other Than Options on Security Futures

September 25, 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 September 24, 2002, the Nasdaq Liffe Markets, LLC ("NQLX") 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 NQLX. 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

NQLX is proposing new rule provisions and rule amendments related to customer margin for security futures contracts. These proposed rule and rule amendments would: (1) Define the term "Security Futures Dealers;" (2) add a provision stating that NQLX's customer margin rule would only apply to products traded on NQLX; (3) add a provision stating that NQLX's customer margin rule would not apply to (a) specified portfolio-margining systems, (b) margin requirements imposed by clearing organizations on their members, (c) "exempted persons" for activities in their own accounts, (d) market-making activities of "Security Futures Dealers," and (e) security futures contracts held in a securities account for a customer; (4) add a provision establishing the minimum initial and maintenance customer margin rates for security futures contracts; (5) add a provision requiring compliance with the customer margin rules jointly promulgated by the Commission and the Commodity Futures Trading Commission ("CFTC"); (6) add a provision establishing four strategy-based offsets, in table form, that would be allowed to reduce the customer margin requirements below the minimum initial and maintenance margin requirements; and (7) add a provision that would specify the

requirements for a market maker to be designated as a Security Futures Dealer by NQLX, which would include, among other requirements (a) holding itself out as being willing to buy and sell specified Security Futures Contracts for its own account on a regular or continuous basis and (b) meeting specified affirmative, minimum two-sided quotation requirements, including requirements related to maximum bid/ask spreads and minimum contract sizes in the front-two delivery months of the security futures contract and/or requirements related to responding to requests for quotation in delivery months other than the first-two delivery months.

Below is the text of the proposed rule change. Proposed new language is italicized.

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Rule 101(a) Definitions. * * *

(72) "Security Futures Dealer"—means a Market Maker designated by NQLX as a Security Futures Dealer that meets the requirements of Rule 403(d) and Rule 403(e).

Rule 334 Customer Margin for Exchange Contracts

(a) General Rules:

(1) *This Rule only applies to Exchange Contracts and not other security futures or futures products listed or traded on other Contract Markets or national securities exchanges or national securities associations.*

(2) *With respect to Security Futures Contracts, this Rule does not apply to:*

(i) *Portfolio-margining systems meeting the requirements of CFTC rule 41.42(c)(2)(i) and SEC rule 400(c)(2)(i);*

(ii) *margin requirements that a Clearing Organization imposes on its members as specified by CFTC rule 41.42(c)(2)(iii) and SEC rule 400(c)(2)(iii);*

(iii) *"exempted persons" for trading in their own accounts as specified in, and defined by, CFTC rules 41.42(c)(2)(iv) and 41.43(a)(9) and SEC rules 400(c)(iv) and 401(a)(9);*

(iv) *market-making activities by Security Futures Dealers as specified in, and defined by, CFTC rule 41.42(c)(2)(iii) and SEC rule 400(c)(2)(iii); or*

(v) *Security Futures Contracts held in a securities account for a Customer, which instead will be subject to the customer margin rules of the Member's designated examining authority pursuant to SEC rule 17d-1.*

(3) *For Exchange Contracts, no Member shall effect a transaction or carry an account for a Customer without*

obtaining margin at the times, in the amounts, and in the forms required by this Rule.

(4) *If a Member fails to obtain and maintain the required minimum margin deposits for a Customer's account pursuant to this Rule, NQLX may require that the Member immediately liquidate all or part of the positions in the Customer's account to decrease or eliminate the margin deficiency.*

(5) *Nothing in this Rule prevents NQLX, a Clearing Organization, or a Member from imposing margin rates or requirements on a Customer that are higher or more stringent than the rates or requirements imposed by this Rule.*

(6) *Terms used in this Rule, but not otherwise defined by these Rules, have the meaning set forth in the Joint Audit Committee's Margins Handbook. In addition, a Member must follow the procedures specified in the Joint Audit Committee's Margins Handbook for the computation, issuance, collection, and offsets for margin calls and corresponding capital charges for the Member unless the Manual is inconsistent with these Rules, in which case these Rules prevail.*

(b) Rates and Requirements:

(1) *A Member carrying a Customer account with Exchange Contracts must collect at least the minimum margin requirements established by NQLX. Except as provided for in Rule 334(g)(2), a Member must collect at least twenty percent of the current market value (as that term is defined by CFTC rule 41.43(a)(4) and SEC rule 401(a)(4)) for each Security Future Contract (whether a long or short position) as minimum initial and maintenance margin from the Customer. For all Exchange Contracts other than Security Futures Contracts, NQLX will publish the minimum initial and maintenance margin rates and other requirements for each Exchange Contract or Group of Exchange Contracts through Notices to Members. Any changes imposed by NQLX to initial or maintenance margin rates or requirements apply to both new and existing positions and NQLX may, within its discretion, establish different margin rates or requirements for different types of accounts.*

(2) *Unless otherwise required by this Rule, a Member must use a risk-based portfolio margining system acceptable to NQLX to calculate the margin rates imposed on a Customer by this Rule.*

(3) *For a long option on an Exchange Contract other than a Security Futures Contract, when the transaction is initiated for a Customer, the Member must collect in full the premium on the long option.*

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

(c) Account Administration, Classification, and Aggregation:

(1) Omnibus Accounts: A Member must calculate margin requirements for an omnibus account (whether domestic or foreign) on a gross basis. However, a Member may impose maintenance margin rates for positions in the omnibus account and need not impose the initial margin rates. To use spread or hedge margin rates, a Member must obtain a written representation from the omnibus account identifying the positions within the account that are spreads or bona fide hedges.

(2) Bona Fide Hedge Accounts: For bona fide hedging transactions and positions as defined by CFTC regulation 1.3(z)(1), a Member may impose maintenance margin rates for the transactions and positions and need not impose the initial margin rates if the Member has a reasonable basis to believe, and the Customer represents in writing that, the transactions or positions are for bona fide hedging.

(3) Aggregation:

(i) When determining margin rates, margin calls, and the release of margin deposits, a Member may aggregate identically-owned accounts within the same regulatory account classification of Customer segregated, Customer secured, and non-segregated.

(ii) To satisfy a margin deficiency, a Member may not apply available free funds from an identically-owned account that has a different regulatory account classification. Instead, the Member must transfer the free funds from one identically-owned account in one regulatory account classification to another identically-owned account with a different regulatory account classification that is undermargined.

(iii) Except for omnibus accounts, a Member may calculate margin requirements on a net basis for concurrent long and short positions in identically-owned accounts within the same regulatory account classification.

(4) Extension of Credit: No Member shall extend or maintain credit to or for a Customer to evade or circumvent any requirements of this Rule. A Member may extend or maintain (or arrange for the extension or maintenance of) credit to or for a Customer to meet the margin requirements of this Rule only if the credit or loan is secured as defined by CFTC regulation 1.17(c)(3) and the proceeds are treated by the Member in accordance with CFTC regulation 1.30.

(d) Type, Form, and Value of Margin Deposits:

(1) Subject to Rule 334(d)(2), a Member must only accept the following assets, securities, or instruments as margin deposits:

(i) U.S. dollars and foreign currencies,
(ii) U.S. government treasury and agency securities,

(iii) municipal securities,
(iv) readily marketable securities (which means securities traded on a "ready market" as defined by SEC rule 15c3-1(c)(11)),

(v) money market mutual funds that meet the requirements of CFTC regulation 1.25 (other than securities issued by the Customer or an affiliate of the Customer), and/or

(vi) irrevocable letters of credit in a form, and issued by banks or trust companies, approved by the Clearing Organization (other than letters of credit issued by the Customer or an affiliate of the Customer).

(2) The assets, securities, and instruments accepted by a Member pursuant to Rule 334(d)(1) to meet a Customer's margin requirements must be and remain unencumbered by third party claims.

(3) If a Member accepts foreign currencies as margin deposits, then the Member must obtain a subordination agreement and value the foreign currencies as required by CFTC Interpretation #12-Deposit of Customer Funds in Foreign Depositories.

(4) If a Member accepts the securities identified in Rule 334(d)(1) as margin deposits, then the Member must value the securities at no greater than the current market value of the securities less any haircuts specified by SEC rule 15c3-1.

(5) A Member must not consider any guarantee of a Customer's account when determining whether required margin in a Customer's account is satisfied.

(e) Margin Calls and Liquidation:

(1) Once additional margin deposits are required pursuant to this Rule, a Member must call for the additional margin as promptly as possible and in any event not more than one business day after the event giving rise to the call. Once the Member calls for the additional margin, the Member must collect the full amount of the required additional margin from a Customer as promptly as possible and in any event within a reasonable time. In a margin call, a Member must require that a Customer deposit additional margin so that the Customer's account at least meets the minimum initial margin requirement (i) when the margin equity in the account initially falls below the minimum maintenance margin requirements and (ii) subsequently when the margin equity plus existing margin calls on the account are less than the minimum maintenance margin requirements.

(2) After a margin call is made by a Member but before the Customer makes the required additional margin deposit, the Member may only accept an Order from the Customer to establish a new position if the Member reasonably believes that the Customer will meet the outstanding margin call within a reasonable time. If a margin call to a Customer is outstanding for an unreasonable time, a Member may only accept Orders from the Customer that will reduce the Customer's margin requirements.

(3) After a margin call is made by a Member, if the Customer fails to deposit the required additional margin deposit within a reasonable time, the Member may, but is not required to, liquidate all or a portion of the Customer's positions to restore the Customer's account to a properly margined level. However, the inability of a Member to liquidate all or a portion of the Customer's positions before the account equity results in a debit or deficit balance does not affect any liability of the Customer to the Member.

(4) A Member must make and retain a written record of the date, time, amount, and other relevant information for all margin calls made (whether made by telephone, in writing, or by other means) as well as margin calls reduced, satisfied, or relieved.

(5) A Member that liquidates all or a portion of the Customer's positions pursuant to Rule 334(e)(3) is not deemed to have extended credit or made a loan to the Customer in violation of this Rule.

(f) Release of Margin:

A Member may only release free funds in connection with a Customer's account if after release the Customer's account has at least free funds at the initial margin requirement level.

(g) Security Futures Contracts:

(1) Unless otherwise provided by this Rule, no Member shall effect a transaction for a Customer in, or carry a Customer account with, Security Futures Contracts without complying with (i) CFTC rules 41.42 through and including 41.48 and SEC rules 400 through and including 406 of the Securities Exchange Act ("CFTC/SEC Margin Regulations") and (ii) Rule 334(a) through and including (g) to the extent consistent with the CFTC/SEC Margin Regulations.

(2) Notwithstanding the initial and maintenance margin rate specified in Rule 334(b)(1) for Security Futures Contracts, a Member may collect at least the initial and maintenance margin rates specified in the table below for the following strategy-based offsetting positions:

Description of offset	Security underlying the security futures contract	Initial margin requirement	Maintenance requirement margin
1. Long Security Futures Contract and short Security Futures Contract on the same underlying security (or index).	Individual stock ¹ or narrow-based security index.	The greater of: (a) 5% of the current market value ² of the long Security Futures Contract; or (b) 5% of the current market value of the short Security Futures Contract.	The greater of: (a) 5% of the current market value value of the long Security Futures Contract; or (b) 5% of the current market value of the short Security Futures Contract.
2. Long (short) a basket of Security Futures Contracts, each based on a narrow-based security index that together tracks the broad-based index ³ and short (long) the broad based-index future.	Narrow-based security index.	5% of the current market value of the long (short) basket of Security Futures Contracts.	5% of the current market value of the long (short) basket of Security Futures Contracts.
3. Long (short) a basket of Security Futures Contracts 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: (a) 5% of the current market value of the long Security Futures Contracts; or (b) 5% of the current market value of the short Security Futures Contracts.	The greater of: (a) 5% of the current market value of the long Security Futures Contracts; or (b) 5% of the current market value of the short Security Futures Contracts.
4. Long (short) a Security Future Contract and short (long) an identical security futures contract traded on a different market ("Non-NQLX Security Futures Contract"). ⁴	Individual stock and narrow-based security index.	The greater of: (a) 3% of the current market value of the long Security Futures Contract (or Non-NQLX Security Futures Contract); or (b) 3% of the current market value of the short Security Futures Contract (or Non-NQLX Security Futures Contract).	The greater of: (a) 3% of the current market value of the long Security Futures Contract (or Non-NQLX Security Futures Contract); or (b) 3% of the current market value of the short Security Futures Contract (or Non-NQLX Security Futures Contract).

¹ For purposes of this table, "individual stock" includes common stock, American Depository Receipts, shares of exchange-traded funds, shares of closed-end management investment companies, or trust-issued receipts.

² For purposes of this table, "current market value" is defined by CFTC rule 41.43(a)(4) and SEC rule 401(a)(4).

³ Baskets of securities or Security Futures Contracts must replicate the securities that comprise the index, and in the same proportions.

⁴ For purposes of this table, a Security Futures Contract (which is traded on NQLX) is considered "identical" to a Non-NQLX Security Futures Contract if the two contracts are issued by the same clearing agency or cleared or guaranteed by the same Derivatives Clearing Organization, have identical contract specifications, and would offset each other at the clearing level.

Rule 403 Market Makers

* * * (d) In addition to the requirements of Rule 403(a) through and including (c), a Market Maker in a Security Futures Contract that is designated as a Security Futures Dealer by NQLX must meet all of the following requirements:

(1) Is a Member;
 (2) is registered as a floor trader or floor broker with the CFTC under section 4f(a)(1) of the CEA or as a dealer with the SEC under section 15(b) of the Securities Exchange Act;

(3) holds itself out as being willing to buy and sell Security Futures Contracts for its own account on a regular or continuous basis and enters into a written agreement that meets, at a minimum, the requirements of Rule 403(e);

(4) maintains records sufficient to prove compliance with the requirements of Rule 403(d) and Rule 403(e), including, but not limited to, documents concerning personnel effecting relevant Orders, relevant trade and cash blotters, relevant stock records, and documents concerning applicable internal system capacity and performance; and

(5) is subject to disciplinary action under Chapter 5 of these Rules for failing to comply with CFTC rules 41.42 through and including 41.48 and SEC rules 400 through and including 406 of the Securities Exchange Act, with

sanctions up to and including removal of the Member's designation as a Security Futures Dealer.

(e) To fulfill the requirements of Rule 403(d)(3), the Security Futures Dealer must meet, at a minimum, either the requirements of Rule 403(e)(1) or the requirements of Rule 403(e)(2):

(1) The Security Futures Dealer must:

(i) Provide continuous two-sided quotations for the first-two delivery months of a specified Security Futures Contract throughout the trading day, subject to relaxation during unusual market conditions as determined by NQLX (such as a fast market in either the Security Futures Contract or the security underlying the Security Futures Contract) at which times the Security Futures Dealer must use its best efforts to quote continuously and competitively; and

(ii) quote, for the first-two delivery months, with (A) a maximum bid/ask spread no more than the greater of \$.10 or 150 percent of the bid/ask spread in the primary market for the security underlying the Security Futures Contract and (B) a minimum number of contracts no less than the lesser of 10 contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the Security Futures Contract; and

(iii) respond to requests for quotation in the specified Security Futures

Contract within 5 seconds for all delivery months other than the first-two delivery months with a two-sided quotation that has (A) a maximum bid/ask spread no more than the greater of \$.20 or 150 percent of the bid/ask spread in the primary market for the security underlying the Security Futures Contract and (B) a minimum number of contracts no less than the lesser of 5 contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the Security Futures Contract.

(2) The Security Futures Dealer must:

(i) Respond to requests for quotation in a specified Security Futures Contract in specified delivery months other than the first-two delivery months with two-sided quotations throughout the trading day, subject to relaxation during unusual market conditions as determined by NQLX (such as a fast market in either the Security Futures Contract or the security underlying the Security Futures Contract) at which times the Security Futures Dealer must use its best efforts to quote competitively; and

(ii) quote, when responding to requests for quotation, within 5 seconds (A) with a maximum bid/ask spread no more than the greater of \$.20 or 150 percent of the bid/ask spread in the primary market for the security underlying the Security Futures

Contract and (B) a minimum number of contracts no less than the lesser of 5 contracts or the corresponding contract size equivalent of the best bid and best offer for the security underlying the Security Futures Contract.

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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, NQLX 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. NQLX 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 Commodity Futures Modernization Act of 2000 ("CFMA") lifted the ban on trading futures on single stocks as well as narrow-based stock indices. The CFMA also established a framework for joint regulation of security futures products by the Commission and the CFTC and gave the Board of Governors of the Federal Reserve System ("Federal Reserve Board") authority to promulgate rules governing initial and maintenance customer margin for these newly permissible products. In turn, the Federal Reserve Board delegated its rulemaking authority under Section 7(c)(2)(B) of the Act³ to the Commission and the CFTC, to be exercised jointly by the two agencies.⁴ Pursuant to that authority, the Commission and the CFTC jointly adopted customer margin requirements for security futures, which are CFTC Rules 41.42 through and including 41.49,⁵ and Rules 400 through and including 406 under the Act,⁶ ("SEC/CFTC Margin Regulations").⁷ The SEC/CFTC Margin Regulations went into effect on September 13, 2002. NQLX seeks to adopt these proposed rule provisions and rule amendments to

comply with Sections 6(h)(3)(L)⁸ and 7(c)(2)(B)⁹ of the Act as well the SEC/CFTC Margin Regulations.

NQLX proposes that its general customer margin rule, NQLX Rule 334, provide that NQLX's customer margin rule only applies to futures products traded on NQLX.¹⁰ NQLX further proposes adding a provision stating that its customer margin rule would not apply in five situations.¹¹ First, while no portfolio-margining system currently meets the criteria of Section 7(c)(2)(B) of the Act¹² and has been approved pursuant to Section 19(b)(2) Act,¹³ proposed NQLX Rule 334(a)(2)(i) would state that NQLX Rule 334 would not apply to portfolio-margining systems meeting the requirements of Rule 400(c)(2)(i) under the Act¹⁴ and CFTC Rule 41.42(c)(2)(i).¹⁵ Second, proposed NQLX Rule 334(a)(2)(ii) would state that NQLX Rule 334 would not apply to margin requirements that "Clearing Organizations" impose on their members.¹⁶ Third, proposed NQLX Rule 334(a)(2)(iii) would state that NQLX Rule 334 would not apply to transactions made by "exempted persons" for their own accounts.¹⁷ Fourth, proposed NQLX Rule 334(a)(2)(iv) would provide that NQLX Rule 334 would not apply to the market-making activities of a "Security Futures Dealer," as that term is defined by

⁸ 15 U.S.C. 78f(h)(3)(L).

⁹ 15 U.S.C. 78g(c)(2)(B).

¹⁰ See Proposed NQLX Rule 334(a)(1).

¹¹ See Proposed NQLX Rule 334(a)(2).

¹² 15 U.S.C. 78g(c)(2)(B).

¹³ 15 U.S.C. 78s(b)(2).

¹⁴ 7 CFR 242.400(c)(2)(i).

¹⁵ 17 CFR 41.42(c)(2)(i).

¹⁶ NQLX defines "Clearing Organizations" to mean "any Derivatives Clearing Organization registered with the CFTC or a securities clearing agency registered with the Commission or both and designated by NQLX as a Clearing Organization for NQLX." NQLX Rule 101(a)(16). In turn, NQLX's rules define "Derivative Clearing Organization" to have the "meaning attributed to it by section 1a(9) of the Commodity Exchange Act ("CEA") and the regulations promulgated thereunder." NQLX Rule 101(a)(26).

¹⁷ For purposes of proposed NQLX Rule 334(a)(2)(iii), "exempted persons" has the meaning prescribed by SEC/CFTC Margin Regulations. Generally, the SEC/CFTC Margin Regulations define an "exempted person" as a member of a national securities exchange, a registered broker-dealer, or registered futures commission merchant that: (1) maintains at least 1,000 active stock, futures, or option accounts for customers other than for, in effect, professional traders such as broker-dealers, future commission merchants, floor brokers, or floor traders trading securities, futures, or commodity options; or (2) earns at least \$10 million in gross revenues on an annual basis from transactions in securities, futures, or commodity options other than from professional traders; or (3) earns at least 10 percent of its gross revenues on an annual basis from transactions in securities, futures, or commodity options other than from professional traders. 17 CFR 240.401(a)(9) and 17 CFR 41.43(a)(9).

proposed NQLX Rules 101(a)(72) and 403(d) and (e). Fifth, proposed NQLX Rule 334(a)(2)(v) would state that NQLX Rule 334 would not apply to Security Futures Contracts that are held in a securities account for a customer, but instead the customer margin rules of the member's designated examining authority ("DEA") pursuant to Rule 17d-1 under the Act¹⁸ would apply.¹⁹ NQLX proposes this last provision because even if NQLX was to impose its customer margin rules on customers that held Security Futures Contracts in securities accounts, NQLX members that have DEAs would still have to apply the customer margin rules of their respective DEA. Therefore, to eliminate unnecessary regulatory duplication, proposed NQLX Rule 334(a)(2)(v) would allow NQLX members to only apply the customer margin rules of their respective DEAs for Security Futures Contracts held in securities accounts.

Consistent with the SEC/CFTC Margin Regulations, NQLX also proposes adding a sentence in its customer margin rule that would establish a minimum margin rate of at least 20 percent as the initial and maintenance margin for both a long and short position in a Security Futures Contract, except when specified offsets are allowed pursuant to proposed NQLX Rule 334(g)(2).²⁰ NQLX further proposes adding subsection (g) to NQLX Rule 334, which would provide that NQLX members could not effect transactions for a customer in, or carry a customer account with, Security Futures Contracts without complying with the SEC/CFTC Margin Regulations as well as all other provisions of NQLX's customer margin rule to the extent they are not inconsistent with the SEC/CFTC Margin Regulations.²¹

Consistent with the SEC/CFTC Margin Regulations, NQLX then proposes that subsection (g)(2) to NQLX Rule 334 would allow reduction of the minimum margin rate established in proposed NQLX Rule 334(b)(1) for specified strategy-based offsets for Security Futures Contracts held by customers. Because NQLX's customer margin rule, as proposed, would only apply to Security Futures Contracts held by customers in futures accounts, only four strategy-based offsets—of the eighteen offsets described in the SEC/CFTC joint release on the SEC/CFTC Margin Regulations—can apply.²² For strategy-

¹⁸ 17 CFR 240.17d-1.

¹⁹ See Proposed NQLX Rule 334(a)(2)(v).

²⁰ See Proposed NQLX Rule 334(b)(1).

²¹ See Proposed NQLX Rule 334(g)(1).

²² See Securities Exchange Act Release No. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002);

³ 15 U.S.C. 78g(c)(2)(B).

⁴ See letter to James E. Newsome, Acting Chairman, CFTC, and Laura S. Unger, Acting Chairman, Commission, from Jennifer J. Johnson, Secretary of the Federal Reserve Board, dated March 6, 2001.

⁵ 17 CFR 41.42 through 41.49.

⁶ 17 CFR 240.400 through 406.

⁷ See Securities Exchange Act Release No. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002).

based offsets for Security Futures Contracts held in securities accounts, NQLX's members would need to apply the offsets adopted by the particular member's DEA. Described briefly below are the four offsets that NQLX proposes as part of NQLX Rule 334(g)(2).

(1) The proposed first offset would be allowed for a calendar or inter-month spread. As proposed, for a long Security Futures Contract and a corresponding short Security Futures Contract on the same underlying individual stock²³ or narrow-based index, both the initial margin and the maintenance margin would be the greater of 5% of the current market value of the long Security Futures Contract or 5% of the current market value of the short Security Futures Contract.

(2) The proposed second offset would be allowed for an inter-index spread, which is subject to basis risk. As proposed, for a long (short) basket of Security Futures Contracts (each of which is based on a narrow-based security index that together tracks a broad-based index) held in combination with a short (long) of the applicable broad-based index, both the initial and the maintenance margin are proposed to be 5% of the current market value of the long (short) basket of Security Futures Contracts.

(3) The proposed third offset would be allowed for an index replication spread, which is subject to basis risk defined by the index's weighting scheme. As proposed, for a long (short) basket of Security Futures Contracts on individual stocks or narrow-based security index that together tracks a narrow-based index held in combination for a short (long) group of Security Futures Contracts held in combination with a short (long) narrow-based index, both the initial and the maintenance margin is proposed to be the greater of (a) 5% of the current market value of the long Security Futures Contracts or (b) 5% of the

current market value of the short Security Futures Contracts.

(4) The proposed fourth offset would be allowed for inter-exchange spreads. As proposed, for a long (short) Security Futures Contract on either an individual stock or a narrow-based index held in combination with an identical (short) long security futures position listed by a different exchange (*i.e.*, a Non-NQLX security futures contract), both the initial and maintenance margin level would be the greater of (a) 3% of the current market value of the long security futures position or (b) 3% of the current market value of the short security futures position.

Finally, for purposes of implementing the exemption from NQLX's customer margin rules provided by proposed NQLX Rule 334(a)(2)(iv) for "Security Futures Dealers," NQLX proposes defining a "Security Futures Dealer" as a market maker²⁴ designated by NQLX as a Security Futures Dealer that meets the requirements of NQLX Rules 403(d) and Rule 403(e). Proposed NQLX Rule 403(d) would then require a Security Futures Dealer to meet all the following requirements: "(1) Is a Member; (2) is registered as a floor trader or floor broker with the CFTC under section 4f(a)(1) of the CEA or as a dealer with the SEC under section 15(b) of the Securities Exchange Act; (3) holds itself out as being willing to buy and sell Security Futures Contracts for its own account on a regular or continuous basis and enters into a written agreement that must meet, at a minimum, the requirements of NQLX Rule 403(e); (4) maintains records sufficient to prove compliance with the requirements of NQLX Rule 403(d) and NQLX Rule 403(e), including, but not limited to, documents concerning personnel effecting relevant Orders, relevant trade and cash blotters, relevant stock records, and documents concerning applicable internal system capacity and performance; and (5) is subject to disciplinary action under Chapter 5 of these Rules for failing to comply with CFTC Rules 41.42 through and including 41.48 and Rules 400 through and including 406 of the Securities Exchange Act, with sanctions up to and including removal of the Member's designation as a Security Futures Dealer."

In turn, NQLX proposes adding NQLX Rule 403(e), which would require a Security Futures Dealer to meet, at least,

specified affirmative minimum two-sided quotation requirements, including requirements related to maximum bid/ask spreads and minimum contract sizes in the front-two delivery months of a Security Futures Contract, as well as requirements when responding to requests for quotation in delivery months other than the first two delivery months.²⁵ Pursuant to proposed Rule 403(d)(3), NQLX would enter into a written agreement with each market maker designated as a Security Futures Dealer. Then, the requirements of proposed Rule 403(e)(1) or the requirements of proposed Rule 403(e)(2) would specify the minimum affirmative quotation obligations that must be part of a written agreement between NQLX and a market maker that is designated as a Security Futures Dealer.

For example, proposed NQLX Rule 403(e)(1) would impose three minimum requirements on the Security Futures Dealer. First, the Security Futures Dealer would have to provide continuous two-sided quotations for the first two delivery months of a specified Security Futures Contract throughout the trading day, subject to relaxation during unusual market conditions as determined by NQLX.²⁶ Second, the Security Futures Dealer would have to quote, for the first two delivery months, with (a) a maximum bid/ask spread of no more than the greater of \$.10 or 150 percent of the bid/ask spread in the primary market for the security underlying the Security Futures Contract and (b) a minimum number of contracts no less than the lesser of 10 contracts or the corresponding contractual size equivalent of the best bid and best offer for the security underlying the Security Futures Contract.²⁷ Finally, the Security Futures Dealer would have to respond to requests for quotation in the specified Security Futures Contract within 5 seconds for all delivery months other than the first two delivery months with a two-sided quotation that has (a) a maximum bid/ask spread of no more than the greater of \$0.20 or 150 percent of the bid/ask spread in the primary market for the security underlying the Security Futures Contract and (b) a minimum number of contracts no less than the lesser of 5 contracts or the corresponding contractual size equivalent of the best bid and best offer

²³ *see also* Rule 403(b)(2) under the Act, 17 CFR 243.403(b)(2); and CFTC Rule 41.45(b)(2), 17 CFR 41.45(b)(2).

²⁴ Because the Commission and CFTC have jointly held that American Depository Receipts, shares of exchange-traded funds, shares of closed-end funds, and trust-issued receipts can serve as the underlying for security futures contracts, for purposes of the offsets in the table that is proposed by NQLX Rule 334(g), "individual stock" includes American Depository Receipts, shares of exchange-traded funds, shares of closed-end funds, and trust-issued receipts. Proposed NQLX Rule 334(g), footnote 4 to offset table; *see also* Joint Order Granting the Modification of Listing Standards Requirements (ADRs), Securities Exchange Act Release No. 44725 (August 20, 2001), and Joint Order Granting the Modification of Listing Standards Requirements (ETFs, TIRs and Closed-End Funds), Securities Exchange Act Release No. 46090 (June 19, 2002), 67 FR 42760 (June 25, 2002).

²⁴ NQLX's rules define a "Market Maker" as "any Member or other Person that enters into a written agreement with NQLX to facilitate liquidity and orderliness for a specified Exchange Contract or Groups of Exchange Contracts pursuant Rule 403." *See* NQLX Rule 101(a)(48).

²⁵ *See* Securities Exchange Act Release No. 46292 (August 1, 2002), 67 FR 53146 (August 14, 2002).

²⁶ *See* Proposed NQLX Rule 403(e)(1)(i).

²⁷ *See* Proposed NQLX Rule 403(e)(1)(ii).

for the security underlying the Security Futures Contract.²⁸

In the alternative, proposed NQLX Rule 403(e)(2) would impose two minimum requirements on the Security Futures Dealer. First, the Security Futures Dealer would have to respond to requests for quotation in a specified Security Futures Contract in specified delivery months other than the first two delivery months with two-sided quotations throughout the trading day.²⁹ Second, the Security Futures Dealer would have to quote, when responding to requests for quotation, within 5 seconds (a) with a maximum bid/ask spread of no more than the greater of \$0.20 or 150 percent of the bid/ask spread in the primary market for the security underlying the Security Futures Contract and (b) a minimum number of contracts no less than the lesser of 5 contracts or the corresponding contractual size equivalent of the best bid and best offer for the security underlying the Security Futures.³⁰

While proposed NQLX Rule 403(e)(1) and proposed NQLX Rule 403(e)(2) both would provide the minimum requirements imposed on market makers designated as Security Futures Dealers, NQLX and the particular Security Futures Dealer would be free to enter into written agreements with more rigorous affirmative obligations (e.g., more narrow maximum bid/ask spreads as well as larger minimum contract sizes). Subject to the requirements of proposed NQLX Rule 403(e)(1) or the requirements of proposed NQLX Rule 403(e)(2), the specific rights and obligations of Security Futures Dealers on NQLX will be a function of NQLX's market structure, which combines an anonymous central order book with a market-maker program to provide continuous liquidity and market depth.

On NQLX, no Security Futures Dealer will have an exclusive franchise in any group or specified Security Futures Contracts. Instead, NQLX expects to have multiple Security Futures Dealers in each Security Futures Contract that will compete with one another (and other market participants) for orders and get rewarded with fills by equaling or bettering the central order book's best bid or offer. Each Security Futures Dealer will have to meet its own specific, affirmative contractual obligations, which cannot be less rigorous than those specified by proposed NQLX Rule 403(e)(1) or proposed NQLX Rule 403(e)(2). In return for and commensurate with those

obligations, the Security Futures Dealer will receive various benefits, which may include the ability to interact with customer orders pursuant to NQLX Rule 418, the ability to participate in a portion of block trades pursuant to NQLX Rule 419, fee rebates, and additional bandwidth allocations.

NQLX will monitor the performance of its Security Futures Dealers and may take a number of actions up to and including termination of the contract of any Security Futures Dealer that fails to sufficiently discharge its contractual obligations. In addition, a Security Futures Dealer will be subject to disciplinary action under NQLX's Rules for failing to comply with the criteria established in proposed NQLX Rule 403(d) as well as NQLX Rule 403(e), with sanctions up to and including removal of the member's designation as a Security Futures Dealer.³¹

2. Statutory Basis

NQLX believes that these proposed rules are necessary to implement the requirements of the CFMA and to establish customer margin rules that: (1) Preserve the financial integrity of markets trading security futures products, (2) prevent systemic risk, (3) are consistent with the margin requirements for comparable exchange-traded options and require initial and maintenance margin levels no lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded options, and (4) are and will remain consistent with the margin requirements established by the Federal Reserve Board under regulation T. NQLX believes that its proposed rules and rule amendments comply with Sections 6(h)(3)(L)³² and 7(c)(2)(B)³³ of the Act as well as the SEC/CFTC Margin Regulations.

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

NQLX does not believe that these proposed rules and rule amendments will result in any burden on competition that is not necessary or appropriate in furtherance of the Act.

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

NQLX neither solicited nor received written comments on these proposed rules or rule amendments.

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

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding, or (ii) as to which the Exchange consents, the Commission will:

(A) By order approve such proposed rule change, as amended; or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. 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, as amended, 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 the filing will also be available for inspection and copying at the principal offices of the Exchange. All submissions should refer to File No. SR-NQLX-2002-01 and should be submitted by insert date 21 days from the date of publication.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³⁴

Margaret H. McFarland,
Deputy Secretary.

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³⁴ 17 CFR 200.30-3(a)(12).

²⁸ See Proposed NQLX Rule 403(e)(1)(iii).

²⁹ See Proposed NQLX Rule 403(e)(2)(i).

³⁰ See Proposed NQLX Rule 403(e)(2)(ii).

³¹ Proposed NQLX Rule 403(d)(5); see also NQLX Rule 514 (Sanction imposed in disciplinary proceedings can include "limitation on activities, functions, or operations, including, but not limited to, removal of designation as a Security Futures Dealer.")

³² 15 U.S.C. 78f(h)(3)(L).

³³ 15 U.S.C. 78g(c)(2)(B).