Notice to Members

APRIL 2003

SUGGESTED ROUTING

Institutional

Legal & Compliance

Options

Senior Management

Trading

Training

KEY TOPICS

Exercise Limits

Options

Position Limits

Equity Option Hedge Exemption

NASD Expands Equity Option Hedge Exemption

Executive Summary

On February 3, 2003, the Securities and Exchange Commission (SEC) approved amendments to NASD's option position and exercise limits for positions established pursuant to certain qualified hedge strategies.[1] These amendments conform NASD's standardized equity option position and exercise limits to recent changes adopted by the Options Exchanges. These amendments also establish new option position and exercise limits for hedged positions involving conventional equity options. The rules, as amended, are set forth in Attachment A.

The amendments are effective immediately.

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8104.

Background and Discussion

On February 3, 2003, the SEC approved changes to NASD's option position and exercise limits.[2] These changes conform NASD's standardized equity option[3] position and exercise limits to recent changes adopted by the Options Exchanges.[4] In particular, the rule change expands NASD's Equity Option Hedge Exemption to establish six qualified hedge strategies. These qualified hedge strategies are:

1. Where each option contract is "hedged" or "covered" by 100 shares of the underlying security 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 equal, and where each long call and short put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.
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 equal, and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.
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 (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.
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.
6. **Back-to-Back Options**—A listed option position hedged on a one-for-one basis with an 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.

Under the rule change, position and exercise limits for standardized equity options are <u>eliminated</u> for qualified hedge strategies that are established solely with standardized options. In addition, the rule change establishes standardized equity option position and exercise limits of <u>five</u> times the standard limit when one component of a qualified hedge strategy is a conventional equity option.[5]

The rule change also modifies NASD's conventional equity option position and exercise limits. Specifically, conventional equity options position and exercise limits under the Equity Option Hedge Exemption are increased to five times the standard limits. The rule change also continues to provide that conventional equity options positions under the Equity Option Hedge Exemption will not be aggregated with standardized equity option and non-hedged conventional equity option positions for position and exercise limit purposes.[6]

Application of the increased limits or exemption is automatic (*i.e.*, it does not require pre-approval from NASD) to the extent that a member identifies that a pre-existing qualified 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 NASD.[7] The increased limits or exemption shall remain in effect to the extent that the exempted position remains intact and NASD is provided with any required supporting documentation.

Finally, the rule change does not change the standard position and exercise limits for unhedged equity options positions. These remain at 13,500, 22,500, 31,500, 60,000 or 75,000, depending on the trading activity of the underlying security.

Endnotes

1 *See* Securities Exchange Act Release No. 47307 (Feb. 3, 2003), 67 Fed. Reg. 6977 (Feb. 11, 2003) (File No. SR-NASD-2002-134) (SEC Approval Order).

2 SEC Order Granting Approval of Proposed Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to the Proposed Rule Change Relating to Exemptions from Options Position and Exercise Limits, Rel. No. 34-42307, 68 Fed. Reg. 6977 (Feb. 11, 2003).

3 A standardized equity option is any equity options contract issued, or subject to issuance by, the Options Clearing Corporation that is not a FLEX Equity Option. NASD Rule 2860(b)(2)(VV).

4 *See* 67 Fed. Reg. 14751 (Mar. 27, 2002) (CBOE); 67 Fed. Reg. 15638 (Apr. 2, 2002) (AMEX); 67 Fed. Reg. 18975 (Apr. 17, 2002) (PCX); 67 Fed. Reg. 34980 (May 16, 2002) (PHLX); and 67 Fed. Reg. 48689 (July 25, 2002) (ISE).

5 A conventional option is any option contract not issued, or subject to issuance, by the Options Clearing Corporation. NASD Rule 2860(b)(2)(N). The option component of a reversal, a conversion or a collar position will be treated as one contract rather than as two contracts.

6 Equity options hedge positions containing both standardized and conventional equity options positons shall be treated as standardized equity options positions for purposes of aggregation.

7 The existing reporting procedures that serve to identify and document hedged positions above a certain threshold continue to apply. Paragraph (b)(5) of NASD Rule 2860 requires reporting to NASD of aggregate positions of 200 or more contracts of the put class and the call class on the same side of the market covering the same underlying security.

ATTACHMENT A

New language is underlined; deletions are in brackets.

2860. Options

(a) No Change

(b) Requirements

(1) and **(2)** No Change

(3) Position Limits

(A) Stock Options--Except in highly unusual circumstances, and with the prior written approval of [the Association] <u>NASD</u> pursuant to the Rule 9600 Series for good cause shown in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, non-member broker, or non-member dealer, an opening transaction through Nasdaq, the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) 13,500 option contracts of the put class and the call class on the same side of the market covering the same underlying security, combining for purposes of this position limit long positions in put options with short positions in call options, and short positions in put options with long positions in call options; or

(ii) 22,500 option[s] contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 22,500 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 option contracts; or

(iii) 31,500 option contracts of the put class and the call class on the same side of the market covering the same underlying security providing that the 31,500 contract position limit shall only be available for option contracts on securities [which] that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 option contracts; or

(iv) 60,000 option[s] contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 60,000 contract position limit shall only be available for option contracts on securities [which] that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 option contracts; or

(v) 75,000 option[s] contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 75,000 contract position limit shall only be available for option contracts on securities [which] that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 option contracts; or

(vi) such other number of stock option[s] contracts as may be fixed from time to time by [the Association] NASD as the position limit for one or more classes or series of options provided that reasonable notice shall be given of each new position limit fixed by [the Association] NASD.

(vii) Equity Option Hedge Exemptions

a. The following qualified hedge strategies and positions described in subparagraphs 1. through 5. below shall be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs 6. and 7. below in which one of the option components consists of a conventional option, shall be subject to a position limit of five times the established position limits contained in subparagraphs (i) through (vi) above. Hedge strategies and positions in conventional options as described in subparagraphs 1. through 5. below shall be subject to a position limit of five times the established limits contained in subparagraphs (i) through (vi) above. Options positions limits established under this subparagraph shall be separate from limits established in other provisions of this rule.

1. Where each option contract is "hedged" or "covered" by 100 shares of the underlying security 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 equal, and where each long call and short put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

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 equal, and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

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 (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

5. Box Spreads—A long call position accompanied by a short put position with the same strike price and a short call position accompanied by a long put position with a different strike price.

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.

7. For reverse conversion, conversion and collar strategies set forth above in subparagraphs 2., 3. and 4., 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.

[a. The following positions, where each option contract is "hedged" by 100 shares of stock or securities readily convertible into or economically equivalent to such stock, or, in the case of an adjusted option contract, the same number of shares represented by the adjusted contract, shall be exempted from established limits contained in paragraphs (i) through (vi) above:]

[1. long call and short stock;]

[2. short call and long stock;]

[3. long put and long stock;]

[4. short put and short stock.]

[b. Except as provided under the OTC Collar Exemption contained in subparagraph (b)(3)(A)(viii), in no event may the maximum allowable position, inclusive of options contracts hedged pursuant to the equity option position limit hedge exemption in subparagraph a. above, exceed three times the applicable position limit established in subparagraph (b)(3)(A)(i) through (v) with respect to standardized equity options, or paragraph (b)(3)(A)(ix) with respect to conventional equity options.]

[(viii) OTC Collar Aggregation Exemption] [a. For purposes of this paragraph (b), the term OTC collar shall mean a conventional equity option position comprised of short (long) calls and long (short) puts overlying the same security that hedge a corresponding long (short) position in that security.]

[b. Notwithstanding the aggregation provisions for short (long) call positions and long (short) put positions contained in subparagraphs (b)(3)(A)(i) through (v) above, the conventional options positions involved in a particular OTC collar transaction need not be aggregated for position limit purposes, provided the following conditions are satisfied:]

[1. the conventional options can only be exercised if they are in-the-money;]

[2. neither conventional option can be sold, assigned, or transferred by the holder without the prior written consent of the writer;]

[3. the conventional options must be European-style (i.e., only exercisable upon expiration) and expire on the same date;]

[4. the strike price of the short call can never be less than the strike price of the long put; and]

[5. neither side of any particular OTC collar transaction can be in-the-money when that particular OTC collar is established.]

[6. the size of the conventional options in excess of the applicable basic position limit for the options established pursuant to subparagraph (b)(3)(A)(ix) must be hedged on a one-to-one basis with the requisite long or short stock position for the duration of the collar, although the same long or short stock position can be used to hedge both legs of the collar.]

[c. For multiple OTC collars on the same security meeting the conditions set forth in subparagraph b. above, all of the short (long) call options that are part of such collars must be aggregated and all of the long (short) put options that are part of such collars must be aggregated, but the short (long) calls need not be aggregated with the long (short) puts.]

[d. Except as provided above in subparagraphs b. and c., in no event may a member fail to aggregate any conventional options contract of the put class and the call class overlying the same equity security on the same side of the market with conventional option positions established in connection with an OTC collar.]

[e. Nothing in this subparagraph (b)(3)(A)(viii) changes the applicable position limit for a particular equity security.]

[(ix)]<u>(viii)</u> Conventional Equity Options

a. For purposes of [sub]paragraph (b), standardized equity option[s] contracts of the put class and call class on the same side of the market overlying the same security shall not be aggregated with conventional equity option[s] contracts or FLEX Equity Option[s] contracts overlying the same security on the same side of the market. Conventional equity option[s] contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a position limit equal to the greater of:

1. the basic limit of 13,500 contracts, or

2. any standardized equity options position limit as set forth in [sub]paragraphs (b)(3)(A)(ii) through (v) for which the underlying security qualifies or would be able to qualify.

b. In order for a security not subject to standardized equity options trading to qualify for an options position limit of more than 13,500 contracts, a member must first demonstrate to <u>NASD's</u> [the Association's] Market Regulation Department that the underlying security meets the standards for such higher options position limit and the initial listing standards for standardized options trading.

(B) No Change