# NASD Notice to Members 99-20

SEC Approves Rule Change Increasing Position Limits On Standardized Equity Options; NASD Reminds Members Of Their Reporting Obligations When Trading Options

## Suggested Routing

- ■ Senior Management
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- □ Continuing Education
- □ Corporate Finance
- □ Executive Representatives
- □ Government Securities
- □ Institutional
- □ Insurance
- ■ Internal Audit
- ■ Legal & Compliance
- □ Municipal
- □ Mutual Fund
- □ Operations
- ■ Options
- □ Registered Representatives
- □ Registration
- □ Research
- □ Syndicate
- □ Systems
- ■ Trading
- □ Training
- □ Variable Contracts

## Executive Summary

On January 11, 1999, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2860(b)(3)(A), tripling the position limits on standardized (exchange-traded) equity options to make them equivalent to the limits on conventional (over-the-counter) equity options overlying the same security. These amendments were effective upon approval.

Separately, NASD Regulation's Market Regulation Department is reminding members of their reporting obligations when trading options.

Questions regarding the amendments to Rule 2860(b)(3)(A) may be directed to Gary L. Goldsholle, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation℠) at (202) 728-8104; and questions regarding members' reporting obligations may be directed to Jospeh Alotto, Supervisor, Market Regulation Department, NASD Regulation, at (301) 590-6845.

## Tripling Standardized Equity Options Position Limits

NASD Rule 2860(b)(3)(A) governs members' activities in standardized, conventional, and FLEX equity options. Standardized options are exchange-traded options issued by the Options Clearing Corporation (OCC) that have standardized terms for strike prices, expiration dates, and the amount of the underlying security. Conventional options are any other options contracts not issued, or subject to issuance, by the OCC. Conventional options are also frequently referred to as over-the-counter options. FLEX equity options are exchange-traded options issued by OCC that give investors the ability, within specified limits, to designate terms of the option (*i.e.*, the exercise price, exercise style, expiration date, or option type).

NASD Rule 2860(b)(3)(A) imposes a ceiling or position limit on the number of conventional and standardized equity options contracts in each class on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls) that can be held or written by a member, a person associated with a member, a customer, or a group of customers acting in concert. NASD Rule 2860(b)(3)(A) provides that the position limits for equity options are determined according to a five-tiered system in which more actively-traded stocks with larger public floats are subject to higher position limits.

The SEC recently approved amendments tripling the limits for standardized equity options.[1] Under the new amendments, the five tiers are: 13,500; 22,500; 31,500; 60,000; and 75,000 contracts. These new limits conform the NASD's position limits for standardized equity options to the increased limits recently approved by the SEC for the options exchanges.[2] These new limits are also the same tiers that are in effect for conventional equity options. Members are reminded that the NASD's limits on standardized equity options are applicable only to those members who are not also members of the exchange on which the options are traded. Members that conduct a business in standardized options but are not members of the exchange on which such options are listed and traded are commonly referred to as "access" firms. By contrast, the NASD's limits on conventional equity options are applicable to all members.

Members also should note that as part of the recent amendments, NASD Regulation deleted the provisions of Rule 2860(b)(3)(A) that established that the limits for conventional equity options are "three times" the limits for standardized equity options overlying the same security. This numerical relationship was established in a prior rule change[3] that was designed to increase the limits on conventional equity options to correspond to the numerical limits that were previously in effect with respect to FLEX equity options.[4] Under current rules, the position limits for standardized and conventional equity options are the same. Thus, the recent increase in limits for standardized equity option position limits did not correspondingly increase the position limits for conventional equity options.

## NASD Reminds Members Of Their Reporting Obligations When Trading Options

Rule 2860(b)(5) addresses members' options reporting obligations and is applicable to all standardized and FLEX option positions established by "access" firms or their customers, and all conventional option positions established by member firms and their customers. Rule 2860(b)(5) requires members to file a report with the NASD if the member's account, a customer's account, or an associated person's account establishes an aggregate options position of 200 or more options contracts (whether long or short) of the put class and the call class on the same side of the market covering the same underlying security or index. In aggregating options on the "same side of the market," long calls in any class of options should be combined with short puts on the same class and short calls should be combined with long puts to determine whether the member has a reporting obligation. Members should not "net out" long and short positions for the same class in the same account (*e.g.*, 200 contracts long and 200 contracts short in the same options class in the same account should *both* be reported).

Members have an obligation to report option positions in the following situations:

- A long and/or short position of 200 or more options contracts of the put class and the call class on the same side of the market is established in the account.

- There is an increase in a previously reported position (*e.g.*, from 225 to 250 contracts).

- There is a decrease in a previously reported position to a position of less than 200 contracts (*e.g.*, 225 contracts to 199 contracts). Once a position has been reduced to less than 200 contracts, no subsequent position reports would have to be filed until the account once again established a long and/or short position of 200 or more contracts of the put class and call class on the same side of the market.

Members are also reminded that intra-day option 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 or index must be reported even if the position decreases to less than 200 contracts by the end of the day. For example, if an option position increases from 199 contracts to 225 contracts at 11:00 a.m., and then at 3:00 p.m. there is a decrease in the position from 225 contracts to 199 contracts, the member firm must file a report to reflect the position at 11:00 a.m. that exceeded 200 option contracts, even though the option position at the end of the day was less than 200 contracts. The member firm is also required to file a report reflecting the decrease in the option position.

To report an option position, members should complete the Option Position Summary Report and file the report with NASD Regulation Market Regulation Department no later than each business day following the establishment of the reportable position. Following this *Notice* are a copy of the Option Position Summary Report, instructions, and a sample report.

## Text Of Amendments

*(Note: New text is underlined; deletions are bracketed.)*

### Rule 2860. Options.

(3) Position Limits

(A) Stock Options--Except in highly unusual circumstances, and with the prior written approval of the Association 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, 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 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) [4,500] <u>13,500</u> 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) [7,500] <u>22,500</u> options contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the [7,500] 22,500 contract position limit shall only be available for option contracts on securities which underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of [7,500] 22,500 option contracts; or

(iii) [10,500] 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 [10,500] 31,500 contract position limit shall only be available for option contracts on securities which underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of [10,500] 31,500 option contracts; or

(iv) [20,000] 60,000 options contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the [20,000] 60,000 contract position limit shall only be available for option contracts on securities which underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of [20,000] 60,000 option contracts; or

(v) [25,000] 75,000 options contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the [25,000] 75,000 contract position limit shall only be available for option contracts on securities which underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of [25,000] 75,000 option contracts; or

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(ix) Conventional Equity Options

a. For purposes of this paragraph (b), standardized equity options 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 options contracts or FLEX Equity Options contracts overlying the same security on the same side of the market. Conventional equity options 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. [three times] the basic limit of [4,500] 13,500 contracts, or

2. [three times] any standardized equity options position limit as set forth in subparagraphs (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 [4,500] 13,500 contracts, a member must first demonstrate to 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.

## Endnotes

[1] 64 Fed. Reg. 2930 (January 19, 1999).

[2] *See* 64 Fed. Reg. 1842 (January 12, 1999) (approving File Nos. SR-CBOE-98-25, SR-Amex-98-22, SR-PCX-98-33, and SR-Phlx-98-36).

[3] 63 Fed. Reg. 23317 (April 28, 1998).

[4] Position limits on FLEX equity options have be eliminated pursuant to a two-year pilot program. *See* 62 Fed. Reg. 48638 (September 16, 1997).