NASD Notice to Members 98-49

SEC Approves Amendments To Rule Regarding Options Position Limits; Effective June 12, 1998

Suggested Routing

- ■ Senior Management
- □ Advertising
- □ 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 June 12, 1998, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rule 2860 and Interpretive Material 2860-1 (IM-2860-1). The amendments to Rule 2860 make three basic changes. First, the amendments increase the position limits on conventional equity options to the greater of three times the basic limit of 4,500 contracts, or three times any standardized equity options position limit for which the underlying security qualifies or would be able to qualify. Second, the amendments disaggregate conventional equity options from standardized equity options and FLEX equity options for position limit purposes, *i.e.*, standardized and FLEX equity option positions do not count towards the position limits for conventional equity options on the same underlying security. Third, the amendments provide that the OTC Collar Aggregation Exemption shall be available with respect to an entire conventional equity options position, not just that portion of the position that is established pursuant to the NASD's Equity Option Hedge Exemption (Hedge Exemption). In addition, the amendments to IM-2860-1 clarify and update the illustrative examples to be consistent with the new amendments and prior increases in the Hedge Exemption. The amendments became effective on June 12, 1998. The text of the amended rules and the *Federal Register* version of the SEC Release are attached. *See* 63 FR 33746 (June 19, 1998).

Questions concerning this *Notice* should be directed to Gary L. Goldsholle, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8104.

Background And Discussion

NASD Rule 2860 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 (OTC) options. FLEX equity options are exchange-traded options issued by the OCC that give investors the ability, within specified limits, to designate certain terms of the option (*i.e.*, the exercise price, exercise style, expiration date, or option type).

NASD Rule 2860(b)(3) 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. The position limits for equity options are established according to a five-tiered system whereby more actively traded securities with larger public floats are subject to higher position limits and less actively traded stocks are subject to lower limits. The current tiers for standardized equity options are 4,500, 7,500, 10,500, 20,000, and 25,000 options contracts.[1] The NASD rules do not specifically govern whether a particular equity option falls within one of the position-limit tiers. Rather, the NASD position limit rule generally provides that the position limit established by an options exchange(s) for a particular equity option is the applicable position limit for purposes of the NASD rule.

On September 9, 1997, the Commission approved a two-year pilot program to eliminate position and exercise limits for FLEX equity options, which are traded on the various options exchanges.[2] In light of the pilot program, NASD Regulation℠ amended its rules governing position and exercise limits for conventional equity options to foster competition between the OTC market and the options exchanges.

NASD Regulation believes that FLEX equity options closely resemble and are economically equivalent to conventional equity options. Accordingly, the amendments to Rule 2860(b)(3) seek to more closely align the NASD's position limit rules for conventional equity options with those for FLEX equity options. In fact, the new limits on conventional equity options correspond to the position limits that were in effect for FLEX equity options prior to the elimination of such limits in the pilot program. Under the new amendments, the position limits for conventional equity options have increased to the greater of three times the basic limit of 4,500 contracts, or three times any higher standardized equity options position limit for which the underlying security qualifies or would be able to qualify.

The new amendments also provide that conventional equity options positions shall not be aggregated with standardized and FLEX equity options positions overlying the same security for position limit purposes. Disaggregation of conventional and other options is necessary to give full effect to the increase in position limits for conventional equity options. Without disaggregation, positions in FLEX equity options or standardized equity options would reduce or potentially even eliminate (in the case of FLEX equity options) the available position limits for conventional equity options.

To illustrate how these new limits work, consider the following example of stock ABCD, which is subject to a position limit of 25,000 standardized equity option contracts. In this example, a market participant could establish a position of 25,000 standardized option contracts on ABCD and an additional 75,000 conventional option contracts on ABCD on the same side of the market, since conventional and standardized option positions would be disaggregated. In addition, the market participant also may have a position of any size in FLEX Equity Options overlying ABCD, since such FLEX equity options would not be aggregated with either the conventional equity options or standardized equity options overlying ABCD.

The NASD's Hedge Exemption[3] provides for an automatic exemption from equity option position limits for accounts that have established hedged positions on a limited one-for-one basis (*i.e.*, 100 shares of stock for one option contract). Under the Hedge Exemption, the largest options position that may be established (combining hedged and unhedged positions) may not exceed three times the basic position limits for either standardized or conventional equity options. The OTC Collar Aggregation Exemption[4] provides that positions in conventional put and call options establishing OTC collars need not be aggregated for position limit purposes. An OTC collar transaction involves the purchase (sale) of a put and the sale (purchase) of a call on the same underlying security to hedge a long (short) stock position.

The new amendments modify the terms of the OTC Collar Aggregation Exemption to apply to an entire conventional equity option position, not just the portion that is established pursuant to the Hedge Exemption. This amendment is consistent with the economic logic underlying the OTC Collar Aggregation Exemption, *i.e.*, that if the terms of the exemption are met, the segments of an OTC collar will never both be in-the-money at the same time or exercised.

To illustrate how these new provisions work, consider the following example of stock ABCD that is subject to a standardized equity option position limit of 25,000 contracts and a conventional equity option position limit of 75,000 contracts. If the market participant had increased the size of its conventional equity options position to 225,000 pursuant to the Hedge Exemption (based upon a limit of three times the 75,000 conventional equity options position limit), the market participant could then establish an OTC collar on ABCD involving 225,000 long (short) calls and 225,000 short (long) puts, for a total of 450,000 contracts.

Finally, members are reminded that Rule 2860(b)(5) imposes reporting obligations on "each account in which the member has an interest . . . and each customer account, which has established an aggregate position of 200 or more option 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." Information reported to the NASD is used by NASD Regulation Market Regulation staff as part of their ongoing market surveillance operations. Additional information concerning members' options reporting obligations may be found in *Notice to Members 94-46*.

Text Of Rule Amendments

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

Rule 2860. Options

(a) No Change

(b) Requirements

(2) Definitions

The following terms shall, unless the context otherwise requires, have the stated meanings:

(A) - (UU) No Change

(VV) Standardized Equity Option—The term "standardized equity option" means any equity options contract issued, or subject to issuance by, The Options Clearing Corporation that is not a FLEX Equity Option.

(WW) - (AAA) Redesignated accordingly.

(3) Position Limits

(A) Stock Options—Except in highly unusual circumstances and with the prior written approval of the Association 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 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 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 contract position limit shall only be available for option contracts on securities which underlie [or qualify to underlie] Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 7,500 option contracts; or

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

(iv) 20,000 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 contract position limit shall only be available for option contracts on securities which underlie [or qualify to underlie] Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 20,000 option contracts; or

(v) 25,000 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 contract position limit shall only be available for option contracts on securities which underlie [or qualify to underlie] Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 25,000 option contracts; or

(vi) such other number of stock options contracts as may be fixed from time to time by the Association 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.

(vii) Equity Option Hedge Exemption

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 subparagraph (b)(3)(A)(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] in paragraph (b)(3)(A)(ix) and in the OTC Collar Exemption contained in paragraph (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 subparagraphs (b)(3)(A)(i)[-] through (v) with respect to standardized equity options, or paragraph (b)(3)(A)(ix) with respect to conventional equity options.

c. The Equity Option Hedge Exemption is a pilot program authorized by the Commission through December 31, 1998.

(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 [established pursuant to the position limit hedge exemption in subparagraph (vii)] 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 paragraph (b)(3)(A)(ix) [(A)(i)-(v) above] 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 [or standardized] 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 paragraph (b)(3)(A)(viii) changes the applicable position limit for a particular equity security.

(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 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 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.

(footnotes deleted)

IM-2860-1. Position Limits

The following examples illustrate the operation of position limits established by Rule 2860(b)(3) (all examples assume a position limit of 4,500 contracts and that the options are standardized options):

(a) Customer A, who is long 4,500 XYZ calls, may at the same time be short 4,500 XYZ calls, since long and short positions in the same class of options (i.e., in calls only, or in puts only) are on opposite sides of the market and are not aggregated for purposes of paragraph (b)(3).

(b) Customer B, who is long 4,500 XYZ calls, may at the same time be long 4,500 XYZ puts. Paragraph (b)(3) does not require the aggregation of long call and long put (or short call and short put) positions, since they are on opposite sides of the market.

(c) Customer C, who is long 1,700 XYZ calls, may not at the same time be short more than 2,800 XYZ puts, since the 4,500 contract limit applies to the aggregation of long call and short put positions in options covering the same underlying security.

Similarly, if Customer C is also short 1,600 XYZ calls, he may not at the same time be long more than 2,900 puts, since the 4,500 contract limit applies separately to the aggregation of short call and long put positions in options covering the same underlying security.

(d) Customer D, who is short 900,000 [450,000] shares of XYZ, may be long up to 13,500 [9,000] XYZ calls, since the "hedge" exemption contained in paragraph (b)(3)(A)(vii) permits Customer D to establish an options position up to 13,500 [9,000] contracts in size. In this instance, 4,500 of the 13,500 [9,000] contracts are permissible under the basic position limit contained in paragraph (b)(3)(A)(i) and the remaining 9,000 [4,500] contracts are permissible because they are hedged by the 900,000 [450,000] short stock position.

Endnotes

[1] Rule 2860(b)(3)(A)(i) through (v).

[2] *See* 62 FR 48683 (September 16, 1997) (approving two-year pilot program eliminating position limits on FLEX equity options traded on the American Stock Exchange, the Chicago Board Options Exchange and the Pacific Exchange); *see also* 63 FR 14743 (March 26, 1998) (amending NASD rules to eliminate position limits on FLEX equity options, consistent with the pilot program).

[3] Rule 2860(b)(3)(A)(vii).

[4] Rule 2860(b)(3)(A)(viii).