

Notice to Members

JANUARY 2005

SUGGESTED ROUTING

Institutional
Legal & Compliance
Options
Senior management
Trading
Training

KEY TOPICS

Delta Hedging
Exercise Limits
Hedge Exemption
Options
OTC Derivatives Dealers
Position Limits
Rule 2860

GUIDANCE

Options Position and Exercise Limits

Exemption for Delta Neutral Positions of OTC Derivatives Dealers; **Effective Date: February 28, 2005**

Executive Summary

On November 29, 2004, the Securities and Exchange Commission (SEC) approved amendments to NASD's rules governing stock options position and exercise limits for stock options positions held by an OTC Derivatives Dealer affiliated with an NASD member firm when the position is "delta neutral."¹ Under the amended rule, a stock options position of an OTC Derivatives Dealer that is "delta neutral" is exempt from position and exercise limits if certain conditions are satisfied. Stock options positions of an OTC Derivatives Dealer that are not delta neutral remain subject to position and exercise limits.

The rules, as amended, are set forth in Attachment A.

The amendments are effective on **February 28, 2005**.

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-8104; or James L. Eastman, Assistant General Counsel, OGC, RPO, at (202) 728-6961.

Background and Discussion

NASD Rule 2860(b)(3)(A) provides, among other things, that no NASD 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 in a stock options contract of any class of stock options if the member has reason to believe that such transaction would result in the account holder, acting alone or in concert with others, directly or indirectly, holding or controlling or being obligated in respect of an aggregate equity options position in excess of specified base limits. The Rule also contains an equity options hedge exemption to allow certain hedged positions in excess of the base limits.

While in recent years NASD has increased in absolute terms the size of its options position and exercise limits as well as the size and scope of available exemptions for hedged positions,² these increases have generally required a one-to-one hedge (e.g., one stock options contract must be hedged by one hundred shares of stock). In practice, however, many firms and customers do not hedge their options positions in this way. Rather, firms typically engage in what is known as “delta hedging,” which varies the number of shares of stock used to hedge an options position based upon the relative sensitivity of the value of the options contract to a change in the price of the underlying stock.³ Delta hedging is a widely accepted risk management tool.

In 1998, the SEC approved rules allowing U.S. securities firms to establish a separately capitalized entity to engage in dealer activities in eligible OTC derivative instruments.⁴ This separately capitalized entity, known as an OTC Derivatives Dealer, receives preferential capital treatment and is not required to be a member of an SRO. In general, most transactions of an OTC Derivatives Dealer (including stock options transactions) must be effected through its fully regulated broker-dealer affiliate, except to the extent otherwise permitted by Rule 15a-1 under the Exchange Act. If the fully regulated broker-dealer affiliate effecting the transaction between the OTC Derivatives Dealer and its counterparty is an NASD member, NASD’s stock options position and exercise limits continue to apply to the transaction.

The SEC recognized that the application of position and exercise limits could deter parties from entering into transactions they otherwise would seek to conduct with an OTC Derivatives Dealer in the absence of such limits.⁵ At the time it approved its rules establishing the framework for OTC Derivatives Dealers, the SEC specifically encouraged NASD to revise its rules to recognize as “hedged” those options positions of an OTC Derivatives Dealer that are hedged on a “delta neutral basis” (*i.e.*, the position is delta neutral or fully hedged with regard to the risk that the price of the stock underlying the options position might change).⁶

The amendments to Rule 2860 fulfill the SEC's request. Under the new provisions in Rule 2860(b)(3)(A)(vii), delta neutral stock options positions of an OTC Derivatives Dealer will be exempt from Rule 2860 if certain conditions are satisfied. The term delta neutral is defined in subparagraph (b)(2)(R) and "describes a stock options position that has been hedged, in accordance with an SEC-approved pricing model, with a portfolio of instruments relating to the same underlying stock to offset the risk that the value of the options position will change with changes in the price of the stock underlying the options position." The new exemption from position and exercise limits for stock options positions that are delta neutral applies only to positions of an OTC Derivatives Dealer; stock options position limits for other persons are unchanged.

The first condition, in subparagraph (b)(3)(A)(vii)b.1, is that a member must receive a written representation from its affiliated OTC Derivatives Dealer stating that the OTC Derivatives Dealer is hedging its stock options positions in accordance with its internal risk management control systems and pricing models approved by the SEC. This written representation will enable NASD to determine when a firm is relying on the delta hedging exemption on behalf of its OTC Derivatives Dealer affiliate. This written representation is not required to be filed with NASD, but must be maintained in accordance with the SEC's and NASD's recordkeeping requirements.

The second condition, in subparagraph (b)(3)(A)(vii)b.2, is that the member must continue to report stock options positions of the OTC Derivatives Dealer, including those that are delta neutral, in accordance with NASD Rule 2860(b)(5). These reports will inform NASD of the OTC Derivatives Dealer's aggregate stock options positions and permit NASD to conduct surveillance for market manipulation, insider trading, and other trading abuses. These position reports must be filed in electronic form with NASD's Market Regulation Department. More detailed information about electronic filing of options positions will be provided in a forthcoming *Notice*.

The third condition, in subparagraph (b)(3)(A)(vii)b.3, is that any stock options position that is not delta neutral must remain subject to position and, by extension, exercise limits (subject, however, to the availability of any other exemptions). An OTC Derivatives Dealer generally employs delta hedging as part of its risk management program, but it is nevertheless possible that an OTC Derivatives Dealer may maintain certain positions that are not fully hedged, so long as the entity as a whole meets the conditions imposed by the SEC. In such cases, only the options contract equivalent of the "net delta" of any such stock options positions, which is the net delta divided by 100, would be subject to position limits. The "net delta" is defined in subparagraph (b)(2)(HH) to mean "the number of shares that must be maintained (either long or short) to offset the risk that the value of a stock options position will change with changes in the price of the stock underlying the options position."

This calculation of an options contract equivalent conforms to former Rule 2860(b)(2)(JJ) (now subparagraph (LL) with this rule amendment), which provides that, for purposes of subparagraphs (3) through (12) of Rule 2860(b), a stock option overlying other than 100 shares “shall be deemed to constitute as many options contracts as that other number of shares divided by 100 (e.g., an option to buy or sell five hundred shares of common stocks shall be considered as five options contracts).”

Importantly, the SEC noted that while Rule 2860(b)(3)(A)(vii) provides for multiple, independent hedge exemptions, to the extent that a position is used to hedge for the purpose of one exemption from position limit requirements, such as the delta hedge exemption, that position could not then be used to take advantage of another exemption from position limit requirements.⁷ Finally, members should be aware that, for purposes of the OTC Derivatives Dealer exemption, only financial instruments relating to the stock underlying a stock options position may be included in any determination of a stock options position’s net delta or whether the stock options position is delta neutral.⁸

Endnotes

- 1 Securities Exchange Act Release No. 50748 (Nov. 29, 2004); 69 FR 70485 (Dec. 6, 2004) (SR-NASD-2004-153). As discussed in this *Notice*, the term “delta neutral” is defined in amended Rule 2860(b)(2)(R).
- 2 See Securities Exchange Act Rel. No. 47307 (Feb. 3, 2003), 68 FR 6977 (Feb. 11, 2003) (SR-NASD-2002-134); Securities Exchange Act Rel. No. 40932 (Jan. 11, 1999), 64 FR 2930 (Jan. 19, 1999) (SR-NASD-98-92); Securities Exchange Act Rel. No. 40087 (June 12, 1998), 63 FR 33746 (June 19, 1998) (SR-NASD-98-23); Securities Exchange Act Rel. No. 39771 (Mar. 19, 1998), 63 FR 14743 (Mar. 26, 1998) (SR-NASD-98-15).
- 3 For example, an option with a delta of .5 will move \$0.50 for every \$1.00 move in the underlying stock.
- 4 Securities Exchange Act Rel. No. 40594 (Oct. 23, 1998), 63 FR 59361 (Nov. 3, 1998) (SEC File No. S7-30-97).
- 5 *Id.* at 59380.
- 6 *Id.*
- 7 69 FR 704865.
- 8 For example, for purposes of the OTC Derivatives Dealer exemption, warrants granting the right to purchase, or convertible bonds that may be converted into, ABC stock might be used to offset the risk associated with a position in ABC puts granting the holder the right to sell ABC stock because the warrants and convertible bonds relate to ABC stock. However, for purposes of the exemption, a position in ABC calls granting the holder the right to purchase ABC stock may not be hedged by puts (or any other financial instrument) overlying any security *other than* ABC stock. That is, a stock options position may be hedged with a financial product other than a stock option, but that financial product must overlie or otherwise be related to the same stock underlying the stock options position being hedged.

ATTACHMENT A

New language is underlined; deletions are in brackets.

2800. SPECIAL PRODUCTS

2860. Options

(a) No Change.

(b) Requirements

(1) No Change.

(2) Definitions

(A) through (Q) No Change.

(R) Delta Neutral—The term “delta neutral” describes a stock options position that has been hedged, in accordance with an SEC-approved pricing model, with a portfolio of instruments relating to the same underlying stock to offset the risk that the value of the options position will change with changes in the price of the stock underlying the options position.

Current (R) through (FF) Renumbered as (S) through (GG).

(HH) Net Delta—The term “net delta” means the number of shares that must be maintained (either long or short) to offset the risk that the value of a stock options position will change with changes in the price of the stock underlying the options position.

Current (GG) through (BBB) Renumbered as (II) through (DDD).

(3) Position Limits

(A) Stock Options—Except in highly unusual circumstances, and with the prior written approval of NASD 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) through (vi) No Change.

(vii) Equity Options Hedge Exemptions

a. No Change.

b. Delta Hedging Exemption for OTC Derivatives Dealer A stock options position of an OTC Derivatives Dealer (as that term is defined in Rule 3b-12 under the Act) affiliated with a member, in standardized or conventional options that is delta neutral, shall be exempt from position limits under this rule if the following conditions are satisfied:

1. The member has obtained a written representation from its affiliated OTC Derivatives Dealer that such entity is hedging its stock options positions in accordance with its internal risk management control systems and pricing models approved by the SEC pursuant to Rules 15c3-1(a)(5) and 15c3-1f under the Act, and that if it ceases to hedge stock options positions in accordance with such systems and models, that it will provide immediate written notice to the member.

2. The member must report in accordance with paragraph (b)(5), all stock options positions (including those that are delta neutral) of 200 or more contracts (whether long or short) on the same side of the market covering the same underlying stock that are effected by the member.

3. Any stock options position of an OTC Derivatives Dealer that is not delta neutral shall be subject to position limits in accordance with this section (subject, however, to the availability of other exemptions). For these purposes, only the option contract equivalent of the net delta of such positions is subject to position limits. The options contract equivalent of the net delta is the net delta divided by 100.

(viii) No Change.

(B) through (D) No Change.

(4) through (24) No Change.