Notice to Members

APRIL 2005

SUGGESTED ROUTING

Institutional
Legal & Compliance
Options
Senior management
Trading
Training

KEY TOPICS

Exercise Limits
Hedge Exemption
Options
Position Limits
Rule 2860

GUIDANCE

Options Position and Exercise Limits

Pilot Program to Increase Position and Exercise Limits for Equity Options and New Reverse Collar Strategy Added to Equity Option Hedge Exemptions

Executive Summary

On March 30, 2005, NASD filed for immediate effectiveness with the Securities and Exchange Commission (SEC) amendments to Rule 2860 increasing, for a pilot period, certain stock options position and exercise limits and adding permanently reverse collars to the enumerated strategies set forth in the equity option hedge exemptions.

The rules, as amended, are set forth in Attachment A. The amendments became effective **March 30, 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.

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Background and Discussion

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.[1] The rule 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.

NASD recently adopted amendments to its options position limits tiers to match changes approved by the SEC or adopted by other self-regulatory organizations (SROs) with options rules.[2] Pursuant to a pilot program that began March 30, 2005, and ends September 2, 2005 (Pilot Period), unless extended, the limits for each of the tiers has increased as follows: 1) 13,500 contracts has been increased to 25,000 contracts; 2) 22,500 contracts has been increased to 50,000 contracts; 3) 31,500 contracts has been increased to 75,000 contracts; 4) 60,000 contracts has been increased to 200,000 contracts; and 5) 75,000 contracts has been increased to 250,000 contracts. These tiers apply to both conventional and standardized options. Options exercise limits, which are set forth in Rule 2860(b)(4), and which incorporate by reference the position limits in Rule 2860(b)(3), also have been increased during the Pilot Period.

Rule 2860(b)(3)(A)(vii) contains the equity option hedge exemptions and allows certain hedged positions to exceed the base limits set forth in the five tiers. Options positions hedged pursuant to one of the qualified equity option hedge strategies are exempt from position limits for standardized options, and subject to position limits of five times the standardized limits for conventional options. At the time the position limits for each of the five tiers were increased, the SEC also approved (or SROs adopted) amendments expanding the available strategies under the equity option hedge exemptions to include "reverse collars."[3] NASD has made a conforming change to its equity option hedge exemptions. The equity option hedge exemption for a reverse collar applies to 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 equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established. The addition of the reverse collar hedging strategy as part of the equity option hedge exemptions is permanent and is not part of the pilot program.

Endnotes

1 A "standardized equity option" is an 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)). A "conventional option" is an option contract not issued, or subject to issuance by, The Options Clearing Corporation (NASD Rule 2860(b)(2)(N)). NASD's limits on standardized equity options are applicable only to those members that are not also members of the exchange on which the option is traded; the limits on conventional options are applicable to all NASD members (NASD Rule 2860(b)(1)(A)).

2 *See* Securities Exchange Act Release No. 51322 (March 4, 2005), 70 FR 12260 (March 11, 2005) (SR-PHLX-2005-17); Securities Exchange Act Release No. 51317 (March 3, 2005), 70 FR 12254 (March 11, 2005) (SR-BSE-2005-10); Securities Exchange Act Release No. 51316 (March 3, 2005), 70 FR 12251 (March 11, 2005) (SR-AMEX-2005-029); Securities Exchange Act Release No. 51295 (March 2, 2005), 70 FR 11292 (March 8, 2005) (SR-ISE-2005-14); Securities Exchange Act Release No. 51286 (March 1, 2005), 70 FR 11297 (March 8, 2005) (SR-PCX-2003-55); Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (SR-CBOE-2003-30).

3 *Id.*

ATTACHMENT A

New language is underlined; deletions are in brackets.

2800. SPECIAL PRODUCTS

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 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) 13,500 (or 25,000 during the pilot period from March 30, 2005, through September 2, 2005 ("Pilot Period")) 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 (or 50,000 during the Pilot Period) 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 22,500 (or 50,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 (or 50,000 during the Pilot Period) option contracts; or

(iii) 31,500 <u>(or 75,000 during the Pilot Period)</u> 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 <u>(or 75,000 during the Pilot Period)</u> contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 <u>(or 75,000 during the Pilot Period)</u> option contracts; or

(iv) 60,000 <u>(or 200,000 during the Pilot Period)</u> option 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 <u>(or 200,000 during the Pilot Period)</u> contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 <u>(or 200,000 during the Pilot Period)</u> option contracts; or

(v) 75,000 <u>(or 250,000 during the Pilot Period)</u> option 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 <u>(or 250,000 during the Pilot Period)</u> contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 <u>(or 250,000 during the Pilot Period)</u> option contracts; or

(vi) No Change.

(vii) Equity Option Hedge Exemptions

a. The following qualified hedge strategies and positions described in subparagraphs 1. through [5] <u>6</u>. below shall be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs [6] <u>7</u>. and [7] <u>8</u>. 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] <u>6</u>. 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. through 3. No Change.

4. Reverse Collars — 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 equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established.

[4.] 5. Collars — 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 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] 6. 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] 7. 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] 8. For reverse conversion, conversion, reverse collar and collar strategies set forth above in subparagraphs 2., 3., 4. and 5. [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.

b. No Change.

(viii) Conventional Equity Options

a. For purposes of this paragraph (b), standardized equity option 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 contracts or FLEX Equity Option contracts overlying the same security on the same side of the market. Conventional equity option 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 (or 25,000 during the Pilot Period) contracts, or

2. any standardized equity options position limit as set forth in 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 (or 25,000 during the Pilot Period) contracts, a member must first demonstrate to NASD'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) through (D) No Change.

(4) through (24) No Change.