Notice to Members

JANUARY 2007

SUGGESTED ROUTING

Options
Legal and Compliance
Institutional
Senior Management
Operations
Trading

KEY TOPICS

Aggregation
Exercise Limits
Index Options
Large Options Position Reporting
Options
Position Limits
Rule 2860

GUIDANCE

Reportable Options Positions, Options Position Limits and Exercise Limits

NASD Announces SEC Approval of Amendments to Rule 2860 and Issues Guidance Concerning Large Options Position Reports and Aggregation of Certain Positions; **Effective Date of Amendments February 12, 2007**

Executive Summary

On November 15, 2006, the Securities and Exchange Commission (SEC) approved a rule change to Rule 2860 that: (1) amends the definition of "underlying index" to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; (2) amends the reporting requirement for certain conventional index options; and (3) allows members to calculate the position limits, in accordance with volume and float criteria specified by NASD, for conventional equity options overlying securities that are part of a designated index (currently the FTSE All-World Index Series).[1] Rule 2860, as amended, is set forth in Attachment A to this *Notice*. The amendments to Rule 2860 become effective on February 12, 2007.

In addition, NASD is issuing this *Notice* to clarify and remind members of their responsibility under Rule 2860 to report certain options positions to NASD. NASD also is providing guidance regarding when it is appropriate to aggregate certain positions, and the process for requesting interpretations.

Questions/Further Information

Questions concerning options position reporting requirements may be directed to Joaquin Gubb, Team Leader, Market Regulation Department, at (240) 386-5102; or Susan Tibbs, Director, Market Regulation Department, at (240) 386-5082. Questions concerning this *Notice* or Rule 2860 in general may be directed to Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; James L. Eastman, Assistant General Counsel, OGC, at (202) 728-9691; or Kathryn M. Moore, Assistant General Counsel, OGC, at (202) 974-2974.

Background

Rule 2860 governs activities in standardized and conventional option contracts. An "option" is defined to mean: "any put, call, straddle, or other option or privilege, which is a 'security' as defined in Section 2(1) of the Securities Act of 1933, as amended, but shall not include any tender offer, registered warrant, right, convertible security, or any other option in respect to which the writer is the issuer of the security which may be purchased or sold upon the exercise of the option."[2] 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."[3] A conventional option is "any option contract not issued, or subject to issuance, by The Options Clearing Corporation."[4]

Large Options Position Reports

Rule 2860(b)(5) requires members to file, or cause to be filed, reports for each account that has an aggregate position of 200 or more of options contracts (whether long or short) on the same side of the market covering the same underlying security or index. These reports are referred to as LOPRs (Large Options Position Reports). As a result of enhancements to the Securities Industry Automation Corporation's (SIAC) LOPR system, NASD eliminated manual reporting of LOPRs for conventional options on July 11, 2005. Today, LOPRs for both standardized and conventional options are filed electronically.

LOPRs subject to the reporting requirements of Rule 2860 should be transmitted to SIAC no later than the close of business on the next day following the day on which the transaction or transactions requiring the filing of such report occurred.[5] In addition, Rule 2860(b)(5)(B) requires each member to promptly report to NASD any instance in which the member has reason to believe that a person, acting alone or in concert with others, has exceeded or is attempting to exceed the applicable exercise limits or position limits set forth in Rule 2860. For more information on the reporting process, please consult *Notice to Members 05-22*.

Since the implementation of the electronic reporting requirements in July 2005, NASD staff has received a significant number of erroneous position reports, including data from non-members[6] and reports of issuer-written options (which are excluded from the scope of Rule 2860 pursuant to paragraph (a)). NASD encourages member firms to review their LOPR filing procedures to ensure that they report only those positions that are required to be reported to avoid unnecessary inquiries by NASD staff.

Applicability of LOPR Requirements

NASD reminds members that its options position reporting requirements apply to "access" firms[7] with respect to positions in standardized options, and all firms with respect to positions in conventional options, except for certain conventional index options as discussed below. In addition, as discussed in *Notices to Members 97-56* and *05-22*, firms availing themselves of the use of one of the equity option hedge exemptions must report the hedge instrument positions.[8]

NASD also is reiterating its prior guidance that Rule 2860 does not apply to certain types of options, including:

- Options in respect to which the writer is the issuer of the security which may be purchased or sold upon the exercise of the option;[9] and
- Warrants issued by a large, publicly held U.S. company on the common stock of a non-U.S. company in which the U.S. company has a 20% ownership interest.[10]

Discussion

Recent Amendments to Rule 2860

On November 15, 2006, the SEC approved a rule change to Rule 2860 that: (1) amends the definition of "underlying index" to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; (2) amends the reporting requirement for certain conventional index options; and (3) allows members to calculate the position limits, in accordance with volume and float criteria specified by NASD, for conventional equity options overlying securities that are part of a designated index (currently the FTSE All-World Index Series).

Definition of "Underlying Index"

As noted above, Rule 2860(b)(5) requires members to report large options positions (*i.e.*, positions of 200 or more contracts) on the same side of the market covering the same underlying index. The SEC recently approved amendments to the definition of "underlying index." The revised definition of "underlying index" encompasses an index underlying (1) a "standardized index option," which is defined as an option that is issued by the OCC that is based on an index or (2) a "conventional index option," which is defined as an option that is not issued by the OCC and overlies a basket or index of securities that underlies a standardized index option or meets certain specified criteria. These criteria include, among other things, that the index or basket comprises nine or more equity securities, no equity security comprises more than 30% of the equity component of the basket's or index's weighting, and each equity security component of the basket or index is either (1) a component security in either the Russell 3000 Index or the FTSE All-World Index Series or (2) the security meets certain capitalization and trading volume criteria.

Reporting Requirement for Certain Conventional Index Options

The SEC also approved amendments to the reporting requirement for certain conventional index options positions. The reporting obligations with respect to positions in standardized index options are unchanged. Thus, "access" firms must continue to report all positions in standardized index options of 200 or more contracts. With respect to positions in conventional index options, the rule change requires members to report options positions of 200 or more contracts only when the conventional index option is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option. As a result, conventional index options based on customized indexes (*i.e.*, indexes that do not underlie, or are not substantially similar to, a standardized index option) are not required to be reported to NASD.

Members also should be aware that a conventional option on an index that does not meet the definition of "conventional index option" will be treated as if the option were deconstructed into its equity security components, and each of the components will be separately subject to position and exercise limits and reporting requirements provided in Rule 2860.[11] For example, suppose there is an option on a basket of securities representing 1 share of ABC, 2 shares of DEF, and 4 shares of GHI. Since the option would not qualify as a conventional index option, it must be deconstructed into its equity security components. If a member has a long call option position representing 100,000 baskets, the member would report a long call option position of 1,000 contracts on ABC (representing 100,000 shares), 2,000 contracts on DEF (representing 200,000 shares) and 4,000 contracts on GHI (representing 400,000 shares). These positions would be aggregated with any other long call or short put option positions the customer may hold on ABC, DEF or GHI.[12]

The burden of demonstrating that an option contract meets the definition of "conventional index option" rests with the member firm. Accordingly, members should maintain detailed records to be able to demonstrate promptly, upon a request from NASD, that a particular "conventional index option" meets the necessary criteria. The amendments to the definition of "underlying index" and the revised reporting requirement become effective on February 12, 2007.

Position Limits on Options Overlying Certain Foreign Securities

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.

Position limits for standardized 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 rules do not specifically govern how a particular equity option falls within one of the tiers. Rather, the position-limit rule provides that the position limit established by the rules of an options exchange for a particular equity option is the applicable position limit for purposes of the NASD rule. The table below lists the positions limits and the corresponding trading volume and float parameters used to determine the applicable limit.[13]

Options Position Limit	Criteria for Underlying Security*
13,500 (or 25,000 during the pilot period from March 30, 2005 through March 1, 2007 or such later date as may be specified (the Pilot Period)).	Applies to those options having an underlying security that does not meet the requirements for a higher option contract limit.
22,500 (or 50,000 during the Pilot Period).	Trading volume of 20,000,000 shares; **or** Trading volume of 15,000,000 shares, and 40,000,000 shares currently outstanding.
31,500 (or 75,000 during the Pilot Period).	Trading volume of 40,000,000 shares; **or** Trading volume of 30,000,000 shares, and 120,000,000 shares currently outstanding.
60,000 (or 200,000 during the Pilot Period).	Trading volume of 80,000,000 shares; **or** Trading volume of 60,000,000 shares, and 240,000,000 shares currently outstanding.
75,000 (or 250,000 during the Pilot Period).	Trading volume of 100,000,000 shares; **or** Trading volume of 75,000,000 shares, and 300,000,000 shares currently outstanding.

* Each as measured during the most recent six-month period.

Position limits for conventional equity options are the same as the limits for standardized equity options. However, because many foreign securities do not have standardized equity options overlying them, conventional equity options overlying foreign securities generally fall into the base tier. Rule 2860(b)(3)(A)(viii) has provisions for a member to make an application to NASD's Market Regulation Department to obtain higher position limits. However, this prior approval process places a significant burden on a member's ability to execute transactions with customers given the time difference between the foreign market and the U.S. market and the time frame in which customers typically desire to trade.

To address this problem, the recent rule change allows members to calculate on their own the position limits for conventional equity options overlying foreign securities that are part of a designated index, currently the FTSE All-World Index Series,[14] using the volume and float criteria described in the table above.

Under the rule, as amended, which becomes effective on February 12, 2007, a member will be able to make a post-trade notice filing within one business day to NASD staff. Such filing shall be made to the Market Regulation Department, to the attention of Options/Foreign Securities Group, at fax number (240) 386-5135, and must provide the necessary trade data and/or current float data to support the member's position limit calculation. NASD staff will review the member's notice filing, and, if it determines that a member incorrectly assigned a position limit, it will notify the firm and instruct it to promptly reduce its position to fall below the appropriate limits determined by the staff.

Position Limit Aggregation Requirements

Separately, NASD is announcing guidance regarding position limit aggregation requirements. NASD reminds members of their obligation under NASD Rule 2860 to aggregate the reports of all accounts under common control or those acting in concert for purposes of determining the proper position limit.[15] "Control" is defined as "the power or ability of an individual or entity to make investment decisions for an account or accounts, or influence directly or indirectly the investment decisions of any person or entity who makes investment decisions for an account."[16] Control is presumed to exist in the following circumstances:[17]

- among all parties to a joint account who have authority to act on behalf of the account;
- among all general partners to a partnership account;
- when a person or entity holds an ownership interest of 10 percent or more in an entity or shares in 10 percent or more of profits and/or losses of an account;[18]
- when accounts have common directors or management; or
- where a person or entity has the authority to execute transactions in an account.

In addition, NASD will consider the following factors in determining whether aggregation of accounts is required:[19]

- similar patterns of trading activity among separate entities;
- the sharing of kindred business purposes and interests;
- whether there is common supervision of the entities which extends beyond assuring adherence to each entity's investment objectives and/or restrictions; and
- the degree of contact and communication between directors and/or managers of separate accounts.

However, the control presumed by one or more of the above powers, abilities or circumstances can be rebutted by proving that a particular factor does not exist or by showing other factors which negate the presumption of control.[20] NASD consideration of whether requests of certain accounts are not required to be aggregated will be handled on a case-by-case basis, and any guidance indicating that accounts need not be aggregated will not be retroactive. Proof of any rebuttal of otherwise presumed control must be submitted to NASD by affidavit and/or such other evidence as may be appropriate in the circumstances. Firms should submit such requests to the Market Regulation Department, to the attention of Options Aggregation Unit, at fax number (240) 386-5135.

Affiliated Broker-Dealers or Trading Units

When analyzing requests for non-aggregation treatment between affiliated broker-dealers or separate and distinct trading units within the same broker-dealer, in addition to undertaking the analyses set forth in Rule 2860(b)(2)(L), NASD will require a broker-dealer(s) to satisfy the following conditions:

- operate the trading unit(s) requesting non-aggregation treatment independently of other trading units controlled by the broker-dealer, and disclose to NASD the trading objective of the trading unit(s) requesting non-aggregation treatment;
- create internal firewalls and information barriers to segregate the trading unit(s) receiving non-aggregation treatment from other trading units controlled by the broker-dealer to prevent the flow of information (*e.g.*, trades, positions, trading strategies);
- conduct all trading activity of the trading unit(s) requesting non-aggregation in a segregated account, which shall be reported to NASD as such;
- maintain regulatory compliance oversight and internal controls and procedures addressing the non-aggregation arrangement;

- retain written records of information concerning the non-aggregated account, including, but not limited to, trading personnel, names of personnel making trading decisions, unusual trading activities, disciplinary action resulting from a breach of the broker-dealer's systems firewalls and information-sharing policies, and the transfer of securities between the broker-dealer's non-aggregated accounts, which information shall be promptly made available to NASD upon its request;
- promptly provide to NASD a written report at such time there is any material change with respect to the non-aggregated account, which NASD will use as a basis to reexamine its determination of non-aggregation; and
- provide a written acknowledgement that NASD reserves the right to (1) impose additional restrictions and conditions with respect to the granting and removal of non-aggregation, and (2) freeze any position above the applicable position limit if NASD determines that aggregation has become necessary due to changed circumstances.

Generally, the presumption of control in these types of arrangements will become easier to rebut as the physical separation between the trading units increases. For example, NASD will require that trading units located on the same floor of a building be physically isolated from each other to ensure that no inappropriate communication will take place between individuals staffed in the applicable trading units.

Effective Date

As noted above, the rule changes to Rule 2860 that: (1) amend the definition of "underlying index" to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; (2) amend the reporting requirement for certain conventional index options; and (3) allow members to calculate the position limits, in accordance with volume and float criteria specified by NASD, for conventional equity options overlying securities that are part of a designated index (currently the FTSE All-World Index Series) become effective on February 12, 2007.

Endnotes

1 *See* Exchange Act Release No. 54755 (November 15, 2006) 71 FR 67675 (November 22, 2006) (File No. SR-NASD-2006-007) (SEC Approval Order).

2 *See* Rule 2860(a).

3 *See* Rule 2860(b)(2)(UU).

4 *See* Rule 2860(b)(2)(N).

5 *See Notice to Members 05-22* (March 2005).

6 In reviewing whether to file LOPRs for positions of non-members, including foreign broker-dealers, members are reminded, as discussed in *Notice to Members 98-92* (November 1998), that options position and exercise limits and reporting obligations apply to transactions with a foreign non-member broker-dealer that are intermediated by members in accordance with the requirements of SEC Rule 15a-6(a)(3).

7 "Access" firms are NASD members that conduct a business in exchange-listed options but are not themselves member of the options exchange of which such options are listed and traded.

8 *See Notices to Members 97-56* (September 1997) and *05-22* (March 2005) for previously issued guidance regarding hedge instrument position reporting.

9 *See* Rule 2860(a).

10 *See Notice to Members 94-46* (June 1994).

11 *See* SEC Approval Order, 71 FR 67675, 67677 n. 21.

12 NASD understands that for deconstructed index options, the strike price field is not able to be completed in the LOPR since each individual security does not have an associated strike price. Therefore, members should complete the strike price field by entering 999999999.

13 *See* Chicago Board Options Exchange Rule 4.11.02; American Stock Exchange Rule 904.07; Philadelphia Stock Exchange Rule 1001.05; NYSE Arca Rule 6.8.06; and International Securities Exchange Rule 412(d).

14 In the event NASD designates another index in addition to or instead of the FTSE All-World Index Series, NASD will publish the designation of the new applicable index in a *Notice to Members* and provide members at least 30 days written notice of the change. SEC Approval Order, 71 FR 67675, 67677 n.23.

15 The calculation of options exercise limits, which is set forth in Rule 2860(b)(4) and incorporates by reference the position limits in Rule 2860(b)(3), also is covered by this account aggregation guidance.

16 Rule 2860(b)(2)(L)(i).

17 *Id.*

18 It is important to note that Rule 2860(b)(2)(L)(i)c.1 emphasizes that an ownership interest of less than 10 percent will not preclude aggregation.

19 Rule 2860(b)(2)(L)(iii).

20 Rule 2860(b)(2)(L)(ii).

ATTACHMENT A

New language is underlined; deletions are in brackets.

2860. Options

(a) No Change.

(b) Requirements

(1) No Change.

(2) Definitions

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

(A) through (M) No Change.

(N) Conventional Index Option — The term "conventional index option" means any options contract not issued, or subject to issuance, by The Options Clearing Corporation that, as of the trade date, overlies a basket or index of securities that:

(i) Underlies a standardized index option; or

(ii) Satisfies the following criteria:

a. The basket or index comprises 9 or more equity securities;

b. No equity security comprises more than 30% of the equity security component of the basket's or index's weighting; and

c. Each equity security comprising the basket or index:

1. is a component security in either the Russell 3000 Index or the FTSE All-World Index Series; or

2. has (A) market capitalization of at least $75 million or, in the case of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, $50 million; and (B) trading volume for each of the preceding six months of at least one million shares or, in the case of each of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, 500,000 shares.

(N) through (UU) renumbered as (O) through (VV).

(WW) Standardized Index Option — The term "standardized index option" means any options contract issued, or subject to issuance, by The Options Clearing Corporation that is based upon an index.

(VV) through (XX) renumbered as (XX) through (ZZ).

(AAA) Underlying Index — The term "underlying index" means an index underlying a Standardized Index Option or a Conventional Index Option.

(YY) through (ZZ) renumbered as (BBB) through (CCC).

(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 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 (vii) No Change.

(viii) Conventional Equity Options

a. No Change.

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.

Provided, however, that for certain securities in an index designated by NASD, a member may claim such higher position limit as permitted in accordance with the volume and float criteria specified by NASD; provided further, that a member claiming a higher position limit under this subparagraph must notify NASD's Market Regulation Department in writing in such form as may be prescribed by NASD and shall be filed no later than the close of business day on the next business day following the day on which the transaction or transactions requiring such limits occurred; and provided further, that the member must agree to reduce its position in the event that NASD staff determines different position limits should apply.

(B) through (D) No Change.

(4) No Change.

(5) Reporting of Options Positions

(A) (i) a. Conventional Options

Each member shall file or cause to be filed with [the Association]NASD a report with respect to each account in which the member has an interest, each account of a partner, officer, director or employee or such member, and each customer, non-member broker, or non-member dealer 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 or index, combining for purposes of this subparagraph long positions in put options with short positions in call options and short positions in put options with long positions in call options, provided, however, that such reporting with respect to positions in conventional index options shall apply only to an option that is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option.

b. No Change.

(ii) No Change.

(B) No Change.

(6) through (24) No Change.

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