

## Delta Hedging Exemption

### FINRA Adopts Rule Amendments that Expand the Delta Hedging Exemptions for Options Positions Limits

Effective Date: February 1, 2008

#### Executive Summary

Effective February 1, 2008, FINRA is expanding the class of entities permitted to use the delta hedging exemption to include other broker-dealers and certain financial institutions.<sup>1</sup> NASD Rule 2860, as amended, is set forth in Attachment A to this *Notice*.

In addition, FINRA is issuing this *Notice* to notify member firms using the delta hedging exemption of how to report options positions, and to remind firms when it is permissible to disaggregate certain option accounts.

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 NASD 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; or Kathryn M. Moore, Assistant General Counsel, OGC, at (202) 974-2974.

January 2008

#### Notice Type

- Rule Amendment

#### Suggested Routing

- Compliance
- Institutional
- Legal
- Operations
- Options
- Senior Management
- Trading

#### Key Topic(s)

- Aggregation
- Delta Hedging
- Exercise Limits
- Options
- Options Reporting
- Position Limits

#### Referenced Rules & Notices

- NASD Rule 2860
- NTM 07-03

## Background and Discussion

NASD Rule 2860(b)(3)(A) provides, among other things, that no FINRA member firm shall effect, for any account, an opening transaction in a stock options contract of any class of stock options if the firm has reason to believe that the transaction would result in the account holder, acting alone or in concert with others, exceeding the applicable position limits. Over the past several years, FINRA has raised the options position limits as well as the size and scope of available exemptions for “hedged” positions. In 2004, the SEC approved amendments to NASD Rule 2860 that provide a delta hedging exemption from stock options position limits for OTC Derivatives Dealers (as defined in Rule 3b-12 of the Securities Exchange Act of 1934).<sup>2</sup> In December 2007, the SEC approved amendments to NASD Rule 2860 that expand the class of entities permitted to use the delta hedging exemption to include other broker-dealers and certain financial institutions.<sup>3</sup>

## Using the Delta Hedging Exemption

Under the recent amendments to the delta hedging exemption, a firm may use delta hedging with the model developed by the Options Clearing Corporation (OCC Model). In addition to using the OCC Model, certain broker-dealers and eligible affiliated entities may use delta hedging with proprietary models (Prop Model). Whether using the OCC Model or a Prop Model, only financial instruments relating to the security underlying an equity options position may be used to determine an equity options position’s net delta or whether the options position is delta neutral. For example, a short position in XYZ calls may be hedged with a long position in XYZ warrants. However, a short position in XYZ calls may not be hedged with a financial instrument relating to security ABC, even if the firm believes that ABC security provides an effective hedge. In addition, firms may not use the same equity or other financial instrument position in connection with more than one hedge exemption.<sup>4</sup> Thus, a stock position used as part of a delta hedge may not also serve as the basis for any other equity option hedge exemption.

Prior to using the delta hedging exemption, firms must provide a written certification to FINRA stating that the member firm and/or its eligible non-member affiliate(s) will use a Permitted Pricing Model (as defined in the rule). **Firms should fax such certifications to FINRA’s Market Regulation Department, to the attention of the Delta Hedging Unit, at (240) 386-5135.**

In addition, if an eligible non-member affiliate ceases to hedge stock options positions in accordance with such systems and models, it must provide immediate written notice to the member firm. A firm is not obligated to use delta hedging after notifying FINRA of such intent. The delta hedging exemption is an alternative to the existing equity options hedge exemptions and may be used on a stock-by-stock basis.

### Delta Hedging and Position Limits

For a firm and/or eligible non-member affiliate using delta hedging, any options position that is not delta hedged remains subject to position and exercise limits. While delta hedging generally is employed as part of an overall risk management program, firms may not necessarily hedge every position to be delta neutral or use delta hedging for every stock options position. In such cases, the net delta will be subject to position limits.

The rule defines “net delta” as the “number of shares that must be maintained (either long or short) to offset the risk that the value of an equity options position will change with incremental changes in the price of the security underlying the options position.”<sup>5</sup> A firm that is not delta neutral must be hedged to the extent that the “options contract equivalent of the net delta” (OCEND) stays within the applicable position limit. The OCEND is calculated by multiplying the net delta with the options position, then dividing the number of shares underlying the options contract (*i.e.*, 100). Once calculated, the OCEND must still be below the applicable position limit.

### Delta Hedging and Position Reporting

Pursuant to NASD Rule 2860(b)(5), a broker-dealer must report (or have reported on its behalf) any options position in which the member firm has an interest, and each customer, non-member broker or non-member dealer account that has established an aggregate 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. The amendments to NASD Rule 2860 that expand the use of the delta hedging exemption retain these reporting thresholds. The obligation to report an aggregate position of 200 or more options contracts applies even if the options position of any member or designated aggregation unit are delta neutral or the OCEND is below 200 contracts. In addition, each firm, or designated aggregation unit pursuant to subparagraph (b)(3)(A)(vii)b.2., that uses the delta hedging exemption for a particular options position must report the OCEND, even if the OCEND is less than 200 contracts.<sup>6</sup>

### Reporting Standardized Options Positions

FINRA member firms that are members of either the OCC or a listed options exchange will continue to report the firm’s standardized options positions as they do today. FINRA firms that currently report options positions to the OCC should file their OCEND to the OCC delta hedging file. The OCC has published a separate circular indicating the specific field definitions and how to submit position information for the OCC delta hedge filing submission.<sup>7</sup>

FINRA “access members”<sup>8</sup> that use delta hedging for standardized options positions required to be reported under NASD Rule 2860 should continue to report the options position through the use of record types 1–5 and record types 6 and 7 (where applicable) of the Securities Industry Automation Corporation’s Large Option Position Reports (LOPR). In addition, FINRA requires access member firms that are not members of the OCC (non-OCC access members) to complete record type C of the LOPR, currently titled OTC Hedge Instrument Position Report, to report the appropriate delta hedging information pursuant to the rule, including the OCEND. Firms should use position 36 to designate whether or not it is using the OCC Model (so designated by using the number “3”), or a Prop Model (so designated by using the number “4”). In addition, non-OCC access member firms should report the OCEND in Record Type C, positions 60–68, titled “Long Position.”<sup>9</sup>

### Reporting Conventional Options Positions

A firm using delta hedging with conventional options as part of its position should report its positions as follows:

#### OCC Members

FINRA firms that currently report options positions to the OCC should file their delta hedging exemption reports to the OCC delta hedging file, even if such position includes or is entirely comprised of conventional options.

#### Non-OCC Members

FINRA firms holding positions in conventional options that are not members of the OCC, but wish to avail themselves of a delta hedging exemption must report options positions of 200 contracts or more to FINRA under NASD Rule 2860. FINRA requires that any delta hedging exemption not reported to the OCC, as described above, be filed with FINRA through the LOPR on Record Type C, OTC Hedge Instrument. Firms should use position 36 to designate whether or not the firm is using the OCC Model (so designated by using the number “3”), or a Prop Model (so designated by using the number “4”). In addition, firms should report the OCEND in Record Type C, positions 60–68, titled “Long Position.” Firms that have designated an options position as delta hedged according to the OCC Model by using the number “3” in field 36 may also report the applicable underlying stock position in fields 69–77.

## Aggregation Units

*NASD Notice to Members (NTM) 07-03* contains guidance on when certain options accounts may be “disaggregated.”<sup>10</sup> Within an aggregation unit, a firm may have trading units using delta hedging and trading units that do not. In these cases, the OCEND of the trading units using delta hedging must be combined with the options positions of the trading units not using delta hedging to arrive at a net delta for the entire aggregation unit. FINRA reminds firms that the options positions of the entire aggregation unit will be subject to the applicable position limits.

A firm may disaggregate an options position held by an entity engaged in delta hedging, or by a separate and distinct trading unit of such entity, provided that:

- the entity demonstrates to FINRA’s satisfaction that no control relationship, as defined in *NTM 07-03*, exists between such affiliates or trading units, and
- the entity has provided FINRA written notice in advance that it intends to be considered separate and distinct from any affiliate, or, as applicable, which trading units within the entity are to be considered separate and distinct from each other for purposes of the delta hedging exemption.<sup>11</sup>

**Firms should fax requests to disaggregate accounts to FINRA’s Market Regulation Department, to the attention of Options Aggregation Unit, at (240) 386-5135.**

## Endnotes

- 1 See Securities Exchange Act Release No. 56916 (December 6, 2007), 72 FR 7-627 (December 12, 2007) (Approval Order for File No. SR-NASD-2007-044).
- 2 See Securities Exchange Act Release No. 50748 (November 29, 2004), 69 FR 70485 (December 6, 2004) (Approval Order for File No. SR-NASD-2004-153); NASD Notice to Members 05-06 (January 2005).
- 3 Customer accounts are not eligible to use the delta hedging exemption.
- 4 See NASD Rule 2860(b)(3)(A)(vii)a.1. through 8. for the list of equity option hedge exemptions.
- 5 See NASD Rule 2860(b)(2)(GG).
- 6 If a member permitted to use delta hedging nevertheless decides to use one of the other eligible exemptions in NASD Rule 2860 (b)(3)(A)(vii) a.1. through 8., then the OCEND is not required to be reported. However, such member would need to otherwise report such stock or options positions as necessary for the particular equity option hedge exemption claimed.
- 7 See The OCC's Delta-Based Position Limit Report Aggregator Report.
- 8 "Access" firms are FINRA members that conduct a business in exchange-listed options but are not themselves members of the options exchange on which such options are listed and traded.
- 9 The OCEND should be reported in the field "Long Position," irrespective of whether the position is long or short.
- 10 See *NASD NTM 07-03* (January 2007).
- 11 In *NTM 07-03*, FINRA has set forth the conditions under which it will deem no control relationship to exist between affiliates and between separate and distinct trading units within the same entity.

## Attachment A

Proposed new language is underlined; proposed 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 (R) No Change.

(S) Delta Neutral — The term “delta neutral” describes an equity [stock] options position that has been fully hedged, in accordance with [an SEC-approved pricing model,] a Permitted Pricing Model as defined in paragraph (b)(3)(A)(vii)b. with a portfolio of instruments including or relating to the same underlying security[stock] to offset the risk that the value of the equity options position will change with incremental changes in the price of the [stock] security underlying the options position.

(T) through (FF) No Change.

(GG) 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 an equity [stock] options position will change with incremental changes in the price of the [stock] security underlying the options position.

(HH) through (KK) No Change.

(LL) Options Contract Equivalent of the Net Delta – the term “options contract equivalent of the net delta” means the net delta divided by the number of shares underlying the options contract.

(LL) through (CCC) renumbered as (MM) 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 Dealers]

[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.]

b. Delta Hedging Exemption For Members and Non-Member Affiliates

An equity options position of a member or non-member affiliate in standardized and/or conventional equity options that is delta neutral under a Permitted Pricing Model shall be exempt from position limits under this rule. Any equity options position of such member or non-member affiliate that is not delta neutral shall be subject to position limits, subject to the availability of other options position limit exemptions. The number of options contracts attributable to a position that is not delta neutral shall be the options contract equivalent of the net delta.

1. Permitted Pricing Model shall mean:

A. A pricing model maintained and operated by the Options Clearing Corporation (“OCC Model”) when used by a member, or non-member affiliate permitted to rely on subparagraphs B or C;

B. A pricing model maintained and used by a member subject to consolidated supervision by the Commission pursuant to Appendix E of Commission Rule 15c3-1, or by an affiliate that is part of such member's consolidated supervised holding company group, in accordance with its internal risk management control system and consistent with the requirements of Appendices E or G, as applicable, to Commission Rule 15c3-1 and Commission Rule 15c3-4 under the Act, as amended from time to time, in connection with the calculation of risk-based deductions from capital or capital allowances for market risk thereunder, provided that the member or affiliate of a member relying on this exemption in connection with the use of such model is an entity that is part of such member's consolidated supervised holding company group;

C. A pricing model maintained and used by a financial holding company ("FHC") or a company treated as an FHC under the Bank Holding Company Act of 1956, or by an affiliate that is part of either such company's consolidated supervised holding company group, in accordance with its internal risk management control system and consistent with:

i. the requirements of the Board of Governors of the Federal Reserve System, as amended from time to time, in connection with the calculation of risk-based adjustments to capital for market risk under capital requirements of the Board of Governors of the Federal Reserve System, provided that the member or affiliate of a member relying on this exemption in connection with the use of such model is an entity that is part of such company's consolidated supervised holding company group; or

ii. the standards published by the Basel Committee on Banking Supervision, as amended from time to time and as implemented by such company's principal regulator, in connection with the calculation of risk-based deductions or adjustments to or allowances for the market risk capital requirements of such principal regulator applicable to such

company – where “principal regulator” means a member of the Basel Committee on Banking Supervision that is the home country consolidated supervisor of such company – provided that the member or affiliate of a member relying on this exemption in connection with the use of such model is an entity that is part of such company’s consolidated supervised holding company group;

D. A pricing model maintained and used by an OTC derivatives dealer registered with the Commission pursuant to SEC Rule 15c3-1(a)(5) in accordance with its internal risk management control system and consistent with the requirements of Appendix F to SEC Rule 15c3-1 and SEC Rule 15c3-4 under the Act, as amended from time to time, in connection with the calculation of risk-based deductions from capital for market risk thereunder, provided that only such OTC derivatives dealer and no other affiliated entity (including a member) may rely on this subparagraph D.; or

E. A pricing model used by a national bank under the National Bank Act maintained and used in accordance with its internal risk management control system and consistent with the requirements of the Office of the Comptroller of the Currency, as amended from time to time, in connection with the calculation of risk-based adjustments to capital for market risk under capital requirements of the Office of the Comptroller of the Currency, provided that only such national bank and no other affiliated entity (including a member) may rely on this exemption.

## 2. Effect on Aggregation of Account Positions

A. Members and non-member affiliates who rely on this exemption must ensure that the Permitted Pricing Model is applied to all positions in or relating to the security underlying the relevant options position that are owned or controlled by such member or non-member affiliate.

B. Notwithstanding subparagraph b.2.A. of this Rule, the Net Delta of an options position held by an entity entitled to rely on this exemption, or by a separate and distinct trading unit of such entity, may be calculated without regard to positions in or relating to the security underlying the options position held by an affiliated entity or by another trading unit within the same entity, provided that:

i. the entity demonstrates to NASD's satisfaction that no control relationship, as defined in Notice to Members 07-03, exists between such affiliates or trading units;\* and

ii. the entity has provided NASD written notice in advance that it intends to be considered separate and distinct from any affiliate, or – as applicable – which trading units within the entity are to be considered separate and distinct from each other for purposes of this exemption.

\* Note: NASD has set forth, in Notice to Members 07-03, the conditions under which it will deem no control relationship to exist between affiliates and between separate and distinct trading units within the same entity.

C. Notwithstanding subparagraph b.2.A. or b.2.B. of this Rule, a member or non-member affiliate who relies on this exemption shall designate, by prior written notice to NASD, each trading unit or entity whose options positions are required under NASD Rules to be aggregated with the option positions of such member or non-member affiliate that is relying on this exemption for purposes of compliance with NASD position limits or exercise limits. In any such case:

i. the Permitted Pricing Model shall be applied, for purposes of calculating such member's or affiliate's net delta, only to the positions in or relating to the security underlying any relevant option position owned and controlled by those entities and trading units who are relying on this exemption; and

ii. the net delta of the positions owned or controlled by the entities and trading units who are relying on this exemption shall be aggregated with the non-exempt option positions of all other entities and trading units whose options positions are required under NASD Rules to be aggregated with the option positions of such member or affiliate.

### 3. Obligations of Members and Affiliates

A member that relies, or whose affiliate relies, upon this exemption must provide a written certification to NASD that it and/or its affiliates are using a Permitted Pricing Model pursuant to subparagraph 1. above and that if the affiliate ceases to hedge stock options positions in accordance with such Permitted Pricing Model, it will provide immediate written notice to the member.

The options positions of a non-member relying on this exemption must be carried by a member with which it is affiliated.

### 4. Reporting

A. Each member must report in accordance with paragraph (b)(5), all equity option 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 security that are effected by the member.

B. In addition, each member on its own behalf or on behalf of a designated aggregation unit pursuant to subparagraph (b)(3)(A)(vii)b.2. shall report in a manner specified by NASD the options contract equivalent of the net delta of each position that represents 200 or more contracts (whether long or short) on the same side of the market covering the same underlying security that are effected by the member.

(viii) No Change.

(B) through (D) No Change.

(4) through (24) No Change.

(c) No Change.

\*\*\*\*\*