October 14, 1998

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-98-78**
Options Position Limits -- Hedge Exemption Pilot Program

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Gary L. Goldsholle, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8104; e-mail goldshog@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan C. Conley
Secretary

Attachment

File No. SR-NASD-98-78
Consists of 16 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. <u>Text of Proposed Rule Change</u>

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (“Act”), NASD Regulation, Inc. (“NASD Regulation”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) a proposed rule change to amend Rule 2860(b)(3)(A)(vii) of the National Association of Securities Dealers, Inc. (“NASD” or “Association”) to make permanent the Association’s Equity Option Hedge Exemption, which has been operating as a pilot program since 1990. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

Rule 2860. Options

* * *

(b)(3)(A)(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 (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 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 subparagraph (b)(3)(A)(i) through (v) with respect to standardized equity options, or subparagraph (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.]

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on October 7, 1998, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on October 8, 1998. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD Rules without recourse to the membership for approval. The proposed rule change will be effective upon approval by the Commission.

(b) Questions regarding this rule filing may be directed to Gary L. Goldsholle, Assistant General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8104.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

Position limits impose a ceiling on the number of options contracts of each options class on the same side of the market that can be held or written by a member, an investor, or a group of investors acting in concert. NASD Rule 2860(b)(3) 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. Currently, the five tiers for standardized equity options[1] are 4,500, 7,500, 10,500, 20,000 and 25,000 contracts. The position limits for conventional equity options[2] are three times the limits for standardized equity options.[3] NASD rules do not specifically govern how a particular equity option falls within one of the five position limit tiers. Rather, the NASD's position limit rule provides that the position limit established by an options exchange for a particular equity option is the applicable position limit for purposes of the NASD's rule.[4]

The NASD's Equity Option Hedge Exemption ("Hedge Exemption") provides for an automatic, limited exemption from position limits for equity options that are hedged using one of the four most commonly used hedge positions: (1) long stock and short calls; (2) long stock and long puts; (3) short stock and long calls; and (4) short stock and short puts. The

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1 Standardized equity options are exchange-traded options issued by the Options Clearing Corporation ("OCC") that have standard terms with respect to strike prices, expiration dates, and the amount of the underlying security.

2 A conventional option is any option contact not issued, or subject to issuance by, the OCC.

3 See 63 Fed. Reg. 33746 (June 19, 1998).

4 For equity options that do not trade on an options exchange, the NASD's position limit rule provides that the limit for conventional equity options shall be three times the basic limit of 4,500 contracts, i.e., 13,500 contracts, unless the member can demonstrate to the Association that the underlying security meets the standards for higher limits and the initial listing standards for standardized options trading.

Hedge Exemption applies to accounts in which the option contract is either (i) hedged by 100 shares of stock, (ii) hedged by securities that are readily convertible into, or economically equivalent to, such stock, or (iii) in the case of an adjusted options contract, hedged by the number of shares represented by the adjusted contract.

Under the Hedge Exemption, the largest standardized equity options position (combining hedged and unhedged positions) that may be established may not exceed three times the basic position limits, i.e., 13,500, 22,500, 31,500, 60,000, or 75,000 contracts, depending on the basic position limits of the underlying security. Likewise, the largest conventional equity options position (combining hedged and unhedged positions) that may be established may not exceed three times the basic position limits on conventional equity options, i.e., 40,500, 67,500, 94,500, 180,000, or 225,000 contracts.

The Hedge Exemption has been operating as pilot program since its inception in 1990.[5] The Commission recently extended the deadline of the pilot program until December 31, 1998, to give the NASD time to adopt it on a permanent basis.[6]

NASD Regulation believes that the Hedge Exemption is an important component of the options position limit rules and should be continued on a permanent basis. NASD Regulation staff has over eight years experience administering the Hedge Exemption and has concluded that it is both an important and necessary tool for market participants to manage their market exposure by allowing them the flexibility to hold larger options positions in cases where such positions are hedged. In addition, NASD Regulation believes that the Hedge Exemption should be made permanent to achieve parity with the other options self-regulatory

5 55 Fed. Reg. 5535 (February 15, 1990).
6 63 Fed. Reg. 19992 (April 22, 1998).

organizations which have in effect a permanent, substantively identical equity option hedge exemption.[7]

Finally, NASD Regulation believes that continuing the Hedge Exemption on a permanent basis will not pose any risk to the options or underlying equity markets. NASD rules require each member to report options positions of any account which has established an aggregate position of 200 or more option contracts of the put class and the call class on the same side of the market covering the same underlying security.[8]

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD believes that making the Hedge Exemption permanent will maintain the depth and liquidity of the options markets by permitting investors to hedge greater amounts of stock than would otherwise be permitted under NASD rules. Making the Hedge Exemption permanent also will promote consistency among the rules of the NASD and the other options self-regulatory organizations. NASD Regulation notes that the higher position limits currently available under the Hedge Exemption have not resulted in disruptions of the underlying equities market, and it will continue monitoring the market effects, if any, from the Hedge Exemption. Lastly, NASD Regulation will continue to monitor

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[7] See American Stock Exchange Rule 904; Chicago Board Options Exchange Rule 4.11; Philadelphia Stock Exchange Rule 1001; Pacific Exchange Rule 6.8.

[8] Rule 2860(b)(5).

use of the Hedge Exemption to ensure that members are complying with all applicable requirements.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Accelerated Effectiveness Pursuant to Section 19(b)(2)

NASD Regulation requests the Commission to find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after its publication in the Federal Register. The proposed rule change makes permanent the Hedge Exemption, which has operated as a pilot program since 1990. NASD Regulation believes that good cause exists to accelerate approval of the proposed rule change because making the Hedge Exemption permanent will maintain the current position limits as well as promote consistency among the options self-regulatory organizations, all of which have a permanent, substantively identical exemption.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: ________________________________

Joan C. Conley, Secretary

October 14, 1998

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34 ; File No. SR-NASD-98-78)

Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to the Equity Option Hedge Exemption

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on , NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons. For the reasons discussed below, the Commission is granting accelerated approval of the proposed rule change.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend Rule 2860(b)(3)(A)(vii) of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), to make permanent the Equity Option Hedge Exemption, which has been operating as a pilot program since 1990. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

Rule 2860. Options

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(b)(3)(A)(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 (i) through (vi) above:

1. long call and short stock;
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b. Except as provided under 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 subparagraph (b)(3)(A)(i) through (v) with respect to standardized equity options, or subparagraph (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.]

II. <u>SELF-REGULATORY ORGANIZATION’S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE</u>

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Position limits impose a ceiling on the number of options contracts of each options class on the same side of the market that can be held or written by a member, an investor, or a group of investors acting in concert. NASD Rule 2860(b)(3) 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. Currently, the five tiers for standardized equity options[1] are 4,500, 7,500, 10,500, 20,000 and 25,000 contracts. The position limits for conventional equity options[2] are three times the limits for standardized equity options.[3] NASD rules do not specifically govern how a particular equity option falls within one of the five position limit tiers. Rather, the NASD's position limit rule provides that the position limit established by an options exchange for a particular equity option is the applicable position limit for purposes of the NASD's rule.[4]

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3 See 63 Fed. Reg. 33746 (June 19, 1998).

4 For equity options that do not trade on an options exchange, the NASD's position limit rule provides that the limit for conventional equity options shall be three times the basic limit of 4,500 contracts i.e., 13,500 contracts, unless the member can demonstrate to the Association that the underlying security meets the standards for higher limits and the initial listing standards for standardized options trading.

The NASD's Equity Option Hedge Exemption ("Hedge Exemption") provides for an automatic, limited exemption from position limits for equity options that are hedged using one of the four most commonly used hedge positions: (1) long stock and short calls; (2) long stock and long puts; (3) short stock and long calls; and (4) short stock and short puts. The Hedge Exemption applies to accounts in which the option contract is either (i) hedged by 100 shares of stock, (ii) hedged by securities that are readily convertible into, or economically equivalent to, such stock, or (iii) in the case of an adjusted options contract, hedged by the number of shares represented by the adjusted contract.

Under the Hedge Exemption, the largest standardized equity options position (combining hedged and unhedged positions) that may be established may not exceed three times the basic position limits, i.e., 13,500, 22,500, 31,500, 60,000, or 75,000 contracts, depending on the basic position limits of the underlying security. Likewise, the largest conventional equity options position (combining hedged and unhedged positions) that may be established may not exceed three times the basic position limits on conventional equity options, i.e., 40,500, 67,500, 94,500, 180,000, or 225,000 contracts.

The Hedge Exemption has been operating as pilot program since its inception in 1990.[5] The Commission recently extended the deadline of the pilot program until December 31, 1998, to give the NASD time to adopt it on a permanent basis.[6]

NASD Regulation believes that the Hedge Exemption is an important component of the options position limit rules and should be continued on a permanent basis. NASD Regulation staff has over eight years experience administering the Hedge Exemption and has

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5 55 Fed. Reg. 5535 (February 15, 1990).

6 63 Fed. Reg. 19992 (April 22, 1998).

concluded that it is both an important and necessary tool for market participants to manage their market exposure by allowing them the flexibility to hold larger options positions in cases where such positions are hedged. In addition, NASD Regulation believes that the Hedge Exemption should be made permanent to achieve parity with the other options self-regulatory organizations which have in effect a permanent, substantively identical equity option hedge exemption.[7]

Finally, NASD Regulation believes that continuing the Hedge Exemption on a permanent basis will not pose any risk to the options or underlying equity markets. NASD rules require each member to report options positions of any account which has established an aggregate position of 200 or more option contracts of the put class and the call class on the same side of the market covering the same underlying security.[8]

2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD believes that making the Hedge Exemption permanent will maintain the depth and liquidity of the options markets by permitting investors to hedge greater amounts of stock than would otherwise be permitted under NASD rules. Making the Hedge Exemption permanent also will promote consistency among the rules of the

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[7] See American Stock Exchange Rule 904; Chicago Board Options Exchange Rule 4.11; Philadelphia Stock Exchange Rule 1001; Pacific Exchange Rule 6.8.

[8] Rule 2860(b)(5).

NASD and the other options self-regulatory organizations. NASD Regulation notes that the higher position limits currently available under the Hedge Exemption have not resulted in disruptions of the underlying equities market, and it will continue monitoring the market effects, if any, from the Hedge Exemption. Lastly, NASD Regulation will continue to monitor use of the Hedge Exemption to ensure that members are complying with all applicable requirements.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. COMMISSION'S FINDINGS AND ORDER GRATING ACCELERATED APPROVAL OF THE PROPOSED RULE CHANGE

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association and, in particular, with the requirements of Section 15A(b)(6). Specifically, the Commission believes that making the Hedge Exemption permanent will accommodate the needs of investors and market participants while at the same time furthering investor protection and the public interest.[9]

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[9] In approving this rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

The Commission finds good cause to approve the proposed rule change, as amended, prior to the 30th day after the date of publication of notice of filing thereof in the Federal Register. Specifically, by accelerating the approval of the NASD's rule proposal, the operation of the Hedge Exemption will continue on a permanent basis, and no longer as a pilot program as it has since 1990. The Commission has previously extended the effectiveness of the Hedge Exemption on an accelerated basis and most recently until December 31, 1998, to allow NASD Regulation sufficient time to adopt it on a permanent basis. The Commission believes that good cause exists to accelerate approval of the proposed rule change because making the Hedge Exemption permanent will maintain the current position limits as well as promote consistency among the options self-regulatory organizations, all of which have a permanent, substantively identical exemption.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act, that the proposed rule change be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary