March 9, 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 2-2/Room 2097

Re: **File No. SR-NASD-98-23**
Amendments to Rule 2860, Options Position Limits

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 WordPerfect 5.1 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-98-23
Consists of 35 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. Text of Proposed Rule Change

(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) of the National Association of Securities Dealers, Inc. ("NASD" or "Association") to: (1) increase the position limits on conventional equity options to three times the basic position limits for standardized equity options on the same security; (2) disaggregate conventional equity options from standardized equity options and FLEX Equity Options for position limit purposes; and (3) provide that the OTC Collar Aggregation Exemption shall be available with respect to an entire conventional equity options position, not just that portion of the position that is established pursuant to the NASD’s Equity Option Hedge Exemption. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.[1]

Rule 2860. Options

* * *

(b) Requirements

(2) Definitions

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

* * *

[1] The proposed new language assumes that the proposed rule changes filed with the Commission in NASD-98-15, on February 13, 1998, and SR-NASD-98-02, on January 20, 1998, have been approved.

(VV) <u>Standardized Equity Option -- The term “standardized equity option” means any equity options contract issued, or subject to issuance by, The Options Clearing Corporation that is not a FLEX Equity Option.</u>

(WW) - (AAA) Redesignated accordingly.

* * *

(3) Position Limits

(A) Stock Options -- Except in highly unusual circumstances and with the prior written approval of the Association 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, 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 would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate <u>standardized equity options</u> position in excess of:

(i) 4,500 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) 7,500 options contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 7,500 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 7,500 option contracts; or

(iii) 10,500 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 10,500 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 10,500 option contracts; or

(iv) 20,000 options contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 20,000 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 20,000 option contracts; or

(v) 25,000 options contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 25,000 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 25,000 option contracts; or

(vi) such other number of stock options contracts as may be fixed from time to time by the Association as the position limit for one or more classes or series of options provided that reasonable notice shall be given of each new position limit fixed by the Association.

(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] in subparagraph (b)(3)(A)(ix) and in the OTC Collar Exemption contained in subparagraph (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)-(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, 1999.

(viii) OTC Collar Aggregation Exemption

a. For purposes of this paragraph (b), the term OTC collar shall mean a conventional equity option position comprised of short (long) calls and long (short) puts overlying the same security that hedge a corresponding long (short) position in that security.

b. Notwithstanding the aggregation provisions for short (long) call positions and long (short) put positions contained in subparagraphs (i) through (v) above, the conventional options positions involved in a particular OTC collar transaction [established pursuant to the position limit hedge exemption in subparagraph (vii)] need not be aggregated for position limit purposes, provided the following conditions are satisfied:

1. the conventional options can only be exercised if they are in-the-money;

2. neither conventional option can be sold, assigned, or transferred by the holder without the prior written consent of the writer;

3. the conventional options must be European-style (i.e., only exercisable upon expiration) and expire on the same date;

4. the strike price of the short call can never be less than the strike price of the long put; and

5. neither side of any particular OTC collar transaction can be in-the-money when that particular OTC collar is established.

6. the size of the conventional options in excess of the applicable basic position limit for the options established pursuant to subparagraph (b)(3)(A)(ix) [(A)(i)-(v) above] must be hedged on a one-to-one basis with the requisite long or short stock position for the duration of the collar, although the same long or short stock position can be used to hedge both legs of the collar.

c. For multiple OTC collars on the same security meeting the conditions set forth in subparagraph b. above, all of the short (long) call options that are part of such collars must be aggregated and all of the long (short) put options that are part of such collars must be aggregated, but the short (long) calls need not be aggregated with the long (short) puts.

d. Except as provided above in subparagraph b. and c., in no event may a member fail to aggregate any conventional [or standardized] options contract of the put class and the call class overlying the same equity security on the same side of the market with conventional option positions established in connection with an OTC collar.

e. Nothing in this subparagraph (viii) changes the applicable position limit for a particular equity security.

<u>(ix) For purposes of this paragraph (b), standardized equity options 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 options contracts or FLEX Equity Options contracts overlying the same security on the same side of the market. Conventional equity options contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a basic position limit equal to three times the applicable position limit established for standardized equity options overlying the security pursuant to subparagraphs A(i)-(v) above and are eligible for the OTC Collar Exemption set forth in subparagraph A(viii) above and the Equity Option Hedge Exemption set forth in subparagraph A(vii) above.</u>

(Footnotes omitted. No changes).

* * *

IM-2860-1. Position Limits

The following examples illustrate the operation of position limits established by Rule 2860(b)(3) (all examples assume a position limit of 4,500 contracts and that the options are standardized options):

(a) Customer A, who is long 4,500 XYZ calls, may at the same time be short 4,500 XYZ calls, since long and short positions in the same class of options (i.e., in calls only, or in puts only) are on opposite sides of the market and are not aggregated for purposes of paragraph (b)(3).

(b) Customer B, who is long 4,500 XYZ calls, may at the same time be long 4,500 XYZ puts. Paragraph (b)(3) does not require the aggregation of long call and long put (or short call and short put) positions, since they are on opposite sides of the market.

(c) Customer C, who is long 1,700 XYZ calls, may not at the same time be short more than 2,800 XYZ puts, since the 4,500 contract limit applies to the aggregation of long call and short put positions in options covering the same underlying security. Similarly, if Customer C is also short 1,600 XYZ calls, he may not at the same time be long more than 2,900 puts, since the 4,500 contract limit applies separately to the aggregation of short call and long put positions in options covering the same underlying security.

(d) Customer D, who is short 900,000 [450,000] shares of XYZ, may be long up to 13,500 [9,000] XYZ calls, since the "hedge" exemption contained in paragraph (b)(3)(A)(vii) permits Customer D to establish an options position up to 13,500

[9,000] contracts in size. In this instance, 4,500 of the 13,500 [9,000] contracts are permissible under the basic position limit contained in paragraph (b)(3)(A)(i) and the remaining 9,000 [4,500] contracts are permissible because they are hedged by the 900,000 [450,000] short stock position.

* * *

(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 the Nasdaq Stock Market, Inc. on November 6, 1996, which authorized this filing with the Commission. The Board of Governors of the NASD declined to call the proposed rule changes for review at its meeting on December 12, 1996. No other action by the NASD is necessary for the filing of the rule change. Pursuant to the Plan of Allocation and Delegation of Functions by NASD to Subsidiaries, Nasdaq staff has provided an opportunity for staff of NASD Regulation, Inc. to consult with it concerning the proposed rule change. Several elements of the proposed rule change were part of SR-NASD-97-67, which was filed previously by Nasdaq on September 7, 1997. The NASD subsequently withdrew SR-NASD-97-67 on February 13, 1997, at the request of the Commission. Due to a reallocation of responsibilities within the NASD, the proposed rule change is now being filed by NASD Regulation.

(b) Questions regarding this rule filing may be directed to Gary L. Goldsholle, Senior Attorney, 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**

NASD Rule 2860(b)(3) provides that the position limit[2] for each equity option is determined according to a five-tiered system whereby more actively traded securities with larger public floats are subject to higher position limits and less actively traded stocks are subject to lower limits.[3] Presently, conventional and standardized equity options are subject to the same position limits, and all equity options overlying a particular equity security on the same side of the market are aggregated for position limit purposes, regardless of whether the option is a conventional, standardized or FLEX Equity Option.[4] On September 9, 1997, the Commission approved a two-year pilot program ("Pilot Program") to eliminate position and

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[2] Position limits impose a ceiling on the number of option 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 an investor or group of investors acting in concert. Exercise limits restrict the number of options contracts that an investor or group of investors acting in concert can exercise within five consecutive business days. Under NASD Rules, exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise, during any five consecutive business days, only the number of options contracts set forth as the applicable position limit for those options classes. See NASD Rules 2860(b)(3) and (4).

[3] Currently, the five tiers are for 4,500, 7,500, 10,500, 20,000, and 25,000 contracts. NASD rules do not specifically govern how a specific 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(s) for a particular equity option is the applicable position limit for purposes of the NASD's rule.

[4] Standardized 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. A conventional option is any other option contract not issued, or subject to issuance by, OCC.

exercise limits for FLEX Equity Options, which are traded on the American Stock Exchange, Inc. ("AMEX"), the Chicago Board Options Exchange, Inc. ("CBOE"), and the Pacific Stock Exchange, Inc. ("PCX") (collectively "Options Exchanges").[5] In light of the Pilot Program, NASD Regulation is proposing to amend its rules governing position and exercise limits for conventional equity options. NASD Regulation has previously filed a proposed rule change to eliminate position and exercise limits on FLEX Equity Options to make its rules consistent with the Pilot Program.[6] The proposed rule change herein is necessary to foster competition between the over-the-counter ("OTC") market and the Options Exchanges.

FLEX Equity Options are exchange-traded options issued by the Options Clearing Corporation ("OCC") that give investors the ability, within specified limits, to designate certain terms of the option (i.e., the exercise price, exercise style, expiration date, and option type). Because they are non-uniform and individually negotiated, FLEX Equity Options closely resemble and are economically equivalent to conventional equity options. Accordingly, to more closely align the NASD's position limit rules for conventional equity options with the rules for FLEX Equity Options, NASD Regulation proposes to amend Rule 2860(b)(3) to provide that: (1) position limits on conventional equity options shall be increased to three times the basic position limits for standardized equity options on the same security; (2) conventional equity options shall be disaggregated from standardized equity options and FLEX Equity Options for position limit purposes; and (3) the OTC Collar Aggregation Exemption shall be available with respect to an entire conventional equity

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[5] See 62 FR 48683 (September 16, 1997).

[6] See SR-NASD-98-15.

options position, not just that portion of the position that is established pursuant to the NASD's Equity Option Hedge Exemption.

The NASD's Equity Option Hedge Exemption[7] provides for an automatic exemption from equity option position limits for accounts that have established hedged positions on a limited one-for-one basis (i.e., 100 shares of stock for one option contract). Under the Equity Option Hedge Exemption, the largest options position that may be established (combining hedged and unhedged positions) may not exceed three times the basic position limit. The OTC Collar Aggregation Exemption[8] provides that positions in conventional put and call options establishing OTC collars need not be aggregated for position limit purposes. An OTC collar transaction involves the purchase (sale) of a put and the sale (purchase) of a call on the same underlying security to hedge a long (short) stock position.

At the present time, NASD Regulation believes that the prudent regulatory approach is to increase position limits on conventional equity options in conjunction with continued availability of the Equity Option Hedge Exemption and OTC Collar Aggregation Exemption. NASD Regulation proposes an incremental approach and in this case believes that increasing position limits for conventional equity options to three times the position limits for standardized equity options is appropriate. These proposed limits correspond to the position limits in effect for FLEX Equity Options prior to the Pilot Program.

NASD Regulation also believes that conventional equity options positions should not be aggregated with standardized and FLEX Equity Options on the same securities for

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[7] Rule 2860(b)(3)(A)(vii).

[8] Rule 2860(b)(3)(A)(viii).

position limit purposes. Disaggregation of conventional and other options is necessary to give full effect to the proposed increase in position limits for conventional equity options. Without disaggregation, positions in FLEX Equity Option or standardized option positions would reduce or potentially even eliminate (in the case of FLEX Equity Options) the available position limits for conventional equity options.

To illustrate how these proposed amendments would work, consider the following example of stock ABCD, which is subject to a position limit of 25,000 standardized equity option contracts. In this example, a market participant could establish a position of 25,000 standardized option contracts on ABCD and an additional 75,000 conventional option contracts on ABCD on the same side of the market, since conventional and standardized option positions would be disaggregated. In addition, the market participant also may have a position of any size in FLEX Equity Options overlying ABCD, since such FLEX Equity Options would not be aggregated with either the conventional equity options or standardized equity options overlying ABCD. Further, by taking advantage of the Equity Option Hedge Exemption, which permits a market participant to assume a hedged options position that is three times the otherwise applicable position limit, a market participant could increase the number of conventional equity options to 225,000 contracts.

NASD Regulation proposes to modify the terms of the OTC Collar Aggregation Exemption to apply to an entire conventional equity option position, not just the portion that is established pursuant to the Equity Option Hedge Exemption. NASD Regulation believes such an amendment is consistent with the economic logic underlying the OTC Collar Aggregation Exemption, i.e., that if the terms of the exemption are met, the segments of an

OTC collar will never both be in-the-money at the same time or exercised. Under current rules, assuming that stock ABCD is subject to a basic position limit of 25,000 contracts, a market participant taking advantage of the Equity Option Hedge Exemption could establish a hedged position on ABCD involving a total of 75,000 conventional equity option contracts (three times the basic limit), including 50,000 contracts that are established under the Equity Option Hedge Exemption. A market participant using the OTC Collar Aggregation Exemption could then establish a conventional position of 50,000 long (short) calls and 50,000 short (long) puts, for a total of 125,000 contracts overlying ABCD. The proposed rule change to the OTC Collar Aggregation Exemption would allow a market participant to establish a collar consisting of two segments, each of which involves a position three times greater than the basic position limit. Consequently, using the example above, a market participant could establish an OTC collar on ABCD involving 75,000 long (short) calls and 75,000 short (long) puts, for a total of 150,000 contracts.[9]

If, however, the basic position limits for conventional options were tripled, as proposed above, the permissible options position established under the OTC Collar Aggregation Exemption would be correspondingly increased. For example, if the market participant in the above example had increased the size of its conventional options position to 225,000 contracts pursuant to the Equity Option Hedge Exemption as proposed above (based

[9] While the OTC Collar Aggregation Exemption is self-effectuating with respect to the hedged components of conventional options positions, NASD Regulation has also permitted members to include non-hedged positions within OTC collars under the terms of the OTC Collar Aggregation Exemption on a pre-approval basis. Accordingly, the instant rule change would turn this pre-approval process for non-hedged components of OTC collars into a self-effectuating process.

upon a limit of three times the 75,000 conventional equity options position limit), the market participant could establish an OTC collar on ABCD involving 225,000 long (short) calls and 225,000 short (long) puts, for a total of 450,000 contracts.

Finally, in addition to the proposed rule changes discussed above, the NASD is proposing to clarify and update the examples contained in IM-2860-1 so that they are consistent with the instant proposal and prior increases in the hedge exemption.

(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 be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change, which will increase the position limits on conventional equity options, disaggregate conventional equity options from exchange-traded equity options for position limit purposes, and provide that the OTC Collar Aggregation Exemption may be utilized with respect to any conventional equity options position, not just that portion of the position that was established pursuant to the NASD's Equity Option Hedge Exemption, will enable market participants to establish larger positions in conventional equity options and, thus, will help to ensure that participants in the OTC options market are not placed at a competitive disadvantage vis-a-vis the exchange markets. In addition, NASD Regulation believes that increasing the position limits for conventional equity options will afford market participants, particularly portfolio managers, issuers, and sophisticated institutional investors, greater flexibility to employ larger options positions when effectuating their investment strategies.

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 Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

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

Date: March 9, 1998

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-98-23)

Self-Regulatory Organizations; Notice of Filing [and Order Granting Accelerated Approval] [and Immediate Effectiveness] of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to an Amendment to the NASD's Options Position Limit Rule

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.

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) of the of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), to: (1) increase the position limits on conventional equity options to three times the basic position limits for standardized equity options on the same security; (2) disaggregate conventional equity options from standardized equity options and FLEX Equity Options for position limit purposes; and (3) provide that the OTC Collar Aggregation Exemption shall be available with respect to an entire conventional equity options position, not just that portion of the position that is established pursuant to the NASD's Equity Option Hedge Exemption. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.[1]

Rule 2860. Options

* * *

(b) Requirements

(2) Definitions

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

* * *

(VV) <u>Standardized Equity Option -- The term "standardized equity option" means any equity options contract issued, or subject to issuance by, The Options Clearing Corporation that is not a FLEX Equity Option.</u>

(WW) - (AAA) Redesignated accordingly.

* * *

(3) Position Limits

(A) Stock Options -- Except in highly unusual circumstances and with the prior written approval of the Association 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, an opening

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[1] The proposed new language assumes that the proposed rule changes filed with the Commission in SR-NASD-98-15, on February 13, 1998, and SR-NASD-98-02, on January 20,

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 would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate standardized equity options position in excess of:

(i) 4,500 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) 7,500 options contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 7,500 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 7,500 option contracts; or

(iii) 10,500 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 10,500 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded

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1998, have been approved.

options qualifying under applicable rules for a position limit of 10,500 option contracts; or

(iv) 20,000 options contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 20,000 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 20,000 option contracts; or

(v) 25,000 options contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 25,000 contract position limit shall only be available for option contracts on securities which underlie or qualify to underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 25,000 option contracts; or

(vi) such other number of stock options contracts as may be fixed from time to time by the Association as the position limit for one or more classes or series of options provided that reasonable notice shall be given of each new position limit fixed by the Association.

(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] in subparagraph (b)(3)(A)(ix) and in the OTC Collar Exemption contained in subparagraph (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)-(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, 1999.

(viii) OTC Collar Aggregation Exemption

a. For purposes of this paragraph (b), the term OTC collar shall mean a conventional equity option position comprised of short (long) calls and long (short) puts overlying the same security that hedge a corresponding long (short) position in that security.

b. Notwithstanding the aggregation provisions for short (long) call positions and long (short) put positions contained in subparagraphs (i) through (v) above, the conventional options positions involved in a particular OTC collar transaction [established pursuant to the position limit hedge exemption in subparagraph (vii)] need not be aggregated for position limit purposes, provided the following conditions are satisfied:

1. the conventional options can only be exercised if they are in-the-money;

2. neither conventional option can be sold, assigned, or transferred by the holder without the prior written consent of the writer;

3. the conventional options must be European-style (i.e., only exercisable upon expiration) and expire on the same date;

4. the strike price of the short call can never be less than the strike price of the long put; and

5. neither side of any particular OTC collar transaction can be in-the-money when that particular OTC collar is established.

6. the size of the conventional options in excess of the applicable basic position limit for the options established pursuant to subparagraph (b)(3)(A)(ix) [(A)(i)-(v) above] must be hedged on a one-to-one basis with the requisite long or short

stock position for the duration of the collar, although the same long or short stock position can be used to hedge both legs of the collar.

c. For multiple OTC collars on the same security meeting the conditions set forth in subparagraph b. above, all of the short (long) call options that are part of such collars must be aggregated and all of the long (short) put options that are part of such collars must be aggregated, but the short (long) calls need not be aggregated with the long (short) puts.

d. Except as provided above in subparagraph b. and c., in no event may a member fail to aggregate any conventional [or standardized] options contract of the put class and the call class overlying the same equity security on the same side of the market with conventional option positions established in connection with an OTC collar.

e. Nothing in this subparagraph (viii) changes the applicable position limit for a particular equity security.

<u>(ix) For purposes of this paragraph (b), standardized equity options 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 options contracts or FLEX Equity Options contracts overlying the same security on the same side of the market. Conventional equity options contracts of the put class and call class on the same side of the market overlying the</u>

same security shall be subject to a basic position limit equal to three times the applicable position limit established for standardized equity options overlying the security pursuant to subparagraphs A(i)-(v) above and are eligible for the OTC Collar Exemption set forth in subparagraph A(viii) above and the Equity Option Hedge Exemption set forth in subparagraph A(vii) above.

(Footnotes omitted. No changes).

* * *

IM-2860-1. Position Limits

The following examples illustrate the operation of position limits established by Rule 2860(b)(3) (all examples assume a position limit of 4,500 contracts and that the options are standardized options):

(a) Customer A, who is long 4,500 XYZ calls, may at the same time be short 4,500 XYZ calls, since long and short positions in the same class of options (i.e., in calls only, or in puts only) are on opposite sides of the market and are not aggregated for purposes of paragraph (b)(3).

(b) Customer B, who is long 4,500 XYZ calls, may at the same time be long 4,500 XYZ puts. Paragraph (b)(3) does not require the aggregation of long call and long put (or short call and short put) positions, since they are on opposite sides of the market.

(c) Customer C, who is long 1,700 XYZ calls, may not at the same time be short more than 2,800 XYZ puts, since the 4,500 contract limit applies to the aggregation of long call and short put positions in options covering the same underlying security.

Similarly, if Customer C is also short 1,600 XYZ calls, he may not at the same time be long more than 2,900 puts, since the 4,500 contract limit applies separately to the aggregation of short call and long put positions in options covering the same underlying security.

(d) Customer D, who is short 900,000 [450,000] shares of XYZ, may be long up to 13,500 [9,000] XYZ calls, since the "hedge" exemption contained in paragraph (b)(3)(A)(vii) permits Customer D to establish an options position up to 13,500 [9,000] contracts in size. In this instance, 4,500 of the 13,500 [9,000] contracts are permissible under the basic position limit contained in paragraph (b)(3)(A)(i) and the remaining 9,000 [4,500] contracts are permissible because they are hedged by the 900,000 [450,000] short stock position.

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II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

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**

NASD Rule 2860(b)(3) provides that the position limit[2] for each equity option is determined according to a five-tiered system whereby more actively traded securities with larger public floats are subject to higher position limits and less actively traded stocks are subject to lower limits.[3] Presently, conventional and standardized equity options are subject to the same position limits, and all equity options overlying a particular equity security on the same side of the market are aggregated for position limit purposes, regardless of whether the option is a conventional, standardized or FLEX Equity Option.[4] On September 9, 1997, the Commission approved a two-year pilot program ("Pilot Program") to eliminate position and

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2 Position limits impose a ceiling on the number of option 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 an investor or group of investors acting in concert. Exercise limits restrict the number of options contracts that an investor or group of investors acting in concert can exercise within five consecutive business days. Under NASD Rules, exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise, during any five consecutive business days, only the number of options contracts set forth as the applicable position limit for those options classes. See NASD Rules 2860(b)(3) and (4).

3 Currently, the five tiers are for 4,500, 7,500, 10,500, 20,000, and 25,000 contracts. NASD rules do not specifically govern how a specific 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(s) for a particular equity option is the applicable position limit for purposes of the NASD's rule.

4 Standardized 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. A conventional option is any other option contract not issued, or subject to issuance by, OCC.

exercise limits for FLEX Equity Options, which are traded on the American Stock Exchange, Inc. ("AMEX"), the Chicago Board Options Exchange, Inc. ("CBOE"), and the Pacific Stock Exchange, Inc. ("PCX") (collectively "Options Exchanges").[5] In light of the Pilot Program, NASD Regulation is proposing to amend its rules governing position and exercise limits for conventional equity options. NASD Regulation has previously filed a proposed rule change to eliminate position and exercise limits on FLEX Equity Options to make its rules consistent with the Pilot Program.[6] The proposed rule change herein is necessary to foster competition between the over-the-counter ("OTC") market and the Options Exchanges.

FLEX Equity Options are exchange-traded options issued by the Options Clearing Corporation ("OCC") that give investors the ability, within specified limits, to designate certain terms of the option (i.e., the exercise price, exercise style, expiration date, and option type). Because they are non-uniform and individually negotiated, FLEX Equity Options closely resemble and are economically equivalent to conventional equity options. Accordingly, to more closely align the NASD's position limit rules for conventional equity options with the rules for FLEX Equity Options, NASD Regulation proposes to amend Rule 2860(b)(3) to provide that: (1) position limits on conventional equity options shall be increased to three times the basic position limits for standardized equity options on the same security; (2) conventional equity options shall be disaggregated from standardized equity options and FLEX Equity Options for position limit purposes; and (3) the OTC Collar Aggregation Exemption shall be available with respect to an entire conventional equity

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[5] See 62 FR 48683 (September 16, 1997).

[6] See SR-NASD-98-15.

options position, not just that portion of the position that is established pursuant to the NASD's Equity Option Hedge Exemption.

The NASD's Equity Option Hedge Exemption[7] provides for an automatic exemption from equity option position limits for accounts that have established hedged positions on a limited one-for-one basis (i.e., 100 shares of stock for one option contract). Under the Equity Option Hedge Exemption, the largest options position that may be established (combining hedged and unhedged positions) may not exceed three times the basic position limit. The OTC Collar Aggregation Exemption[8] provides that positions in conventional put and call options establishing OTC collars need not be aggregated for position limit purposes. An OTC collar transaction involves the purchase (sale) of a put and the sale (purchase) of a call on the same underlying security to hedge a long (short) stock position.

At the present time, NASD Regulation believes that the prudent regulatory approach is to increase position limits on conventional equity options in conjunction with continued availability of the Equity Option Hedge Exemption and OTC Collar Aggregation Exemption. NASD Regulation proposes an incremental approach and in this case believes that increasing position limits for conventional equity options to three times the position limits for standardized equity options is appropriate. These proposed limits correspond to the position limits in effect for FLEX Equity Options prior to the Pilot Program.

NASD Regulation also believes that conventional equity options positions should not be aggregated with standardized and FLEX Equity Options on the same securities for

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[7] Rule 2860(b)(3)(A)(vii).

[8] Rule 2860(b)(3)(A)(viii).

position limit purposes. Disaggregation of conventional and other options is necessary to give full effect to the proposed increase in position limits for conventional equity options. Without disaggregation, positions in FLEX Equity Option or standardized option positions would reduce or potentially even eliminate (in the case of FLEX Equity Options) the available position limits for conventional equity options.

To illustrate how these proposed amendments would work, consider the following example of stock ABCD, which is subject to a position limit of 25,000 standardized equity option contracts. In this example, a market participant could establish a position of 25,000 standardized option contracts on ABCD and an additional 75,000 conventional option contracts on ABCD on the same side of the market, since conventional and standardized option positions would be disaggregated. In addition, the market participant also may have a position of any size in FLEX Equity Options overlying ABCD, since such FLEX Equity Options would not be aggregated with either the conventional equity options or standardized equity options overlying ABCD. Further, by taking advantage of the Equity Option Hedge Exemption, which permits a market participant to assume a hedged options position that is three times the otherwise applicable position limit, a market participant could increase the number of conventional equity options to 225,000 contracts.

NASD Regulation proposes to modify the terms of the OTC Collar Aggregation Exemption to apply to an entire conventional equity option position, not just the portion that is established pursuant to the Equity Option Hedge Exemption. NASD Regulation believes such an amendment is consistent with the economic logic underlying the OTC Collar Aggregation Exemption, i.e., that if the terms of the exemption are met, the segments of an

OTC collar will never both be in-the-money at the same time or exercised. Under current rules, assuming that stock ABCD is subject to a basic position limit of 25,000 contracts, a market participant taking advantage of the Equity Option Hedge Exemption could establish a hedged position on ABCD involving a total of 75,000 conventional equity option contracts (three times the basic limit), including 50,000 contracts that are established under the Equity Option Hedge Exemption. A market participant using the OTC Collar Aggregation Exemption could then establish a conventional position of 50,000 long (short) calls and 50,000 short (long) puts, for a total of 125,000 contracts overlying ABCD. The proposed rule change to the OTC Collar Aggregation Exemption would allow a market participant to establish a collar consisting of two segments, each of which involves a position three times greater than the basic position limit. Consequently, using the example above, a market participant could establish an OTC collar on ABCD involving 75,000 long (short) calls and 75,000 short (long) puts, for a total of 150,000 contracts.[9]

If, however, the basic position limits for conventional options were tripled, as proposed above, the permissible options position established under the OTC Collar Aggregation Exemption would be correspondingly increased. For example, if the market participant in the above example had increased the size of its conventional options position to 225,000 contracts pursuant to the Equity Option Hedge Exemption as proposed above (based

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[9] While the OTC Collar Aggregation Exemption is self-effectuating with respect to the hedged components of conventional options positions, NASD Regulation has also permitted members to include non-hedged positions within OTC collars under the terms of the OTC Collar Aggregation Exemption on a pre-approval basis. Accordingly, the instant rule change would turn this pre-approval process for non-hedged components of OTC collars into a self-effectuating process.

upon a limit of three times the 75,000 conventional equity options position limit), the market participant could establish an OTC collar on ABCD involving 225,000 long (short) calls and 225,000 short (long) puts, for a total of 450,000 contracts.

Finally, in addition to the proposed rule changes discussed above, the NASD is proposing to clarify and update the examples contained in IM-2860-1 so that they are consistent with the instant proposal and prior increases in the hedge exemption.

(2) **Statutory Basis**

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[10] which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. NASD Regulation believes that the proposed rule change, which will increase the position limits on conventional equity options, disaggregate conventional equity options from exchange-traded equity options for position limit purposes, and provide that the OTC Collar Aggregation Exemption may be utilized with respect to any conventional equity options position, not just that portion of the position that was established pursuant to the NASD's Equity Option Hedge Exemption, will enable market participants to establish larger positions in conventional equity options and, thus, will help to ensure that participants in the OTC options market are not placed at a competitive disadvantage vis-a-vis the exchange markets. In addition, NASD Regulation believes that increasing the position limits for conventional equity options will afford market participants, particularly portfolio managers, issuers, and sophisticated institutional investors, greater flexibility to employ larger options positions when effectuating their investment strategies.

(B) <u>Self-Regulatory Organization's Statement on Burden on Competition</u>

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) <u>Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others</u>

Written comments were neither solicited nor received.

III. <u>DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION</u>

Within 35 days of the date of publication of this notice in the <u>Federal Register</u> or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

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[10] 15 U.S.C. 78f(b)(5).

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].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[11]

Jonathan G. Katz
Secretary

[11] 17 CFR 200.30-3(a)(12).