January 20, 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-98-02**
Rule 2860, Option Position Limits: Extension of 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 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-98-02
Consists of 16 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

File No. SR-NASD-98-02

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)(c) of the National Association of Securities Dealers, Inc. (“NASD” or “Association”) to extend, until December 31, 1999, the Association’s pilot program for exemptions from equity option position limits for certain hedged positions (“hedge exemption pilot program”). 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 paragraph (b)(3)(A)(i) - (v).

c. The Equity Option Hedge Exemption is a pilot program authorized by the Commission through December 31, 1999[7].

* * *

(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 NASD at its meeting on September 19-20, 1988, which authorized the filing of the rule change with the SEC. No other action by the NASD is necessary for the filing of the proposed rule change.

(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**

On February 9, 1990, the Commission approved the NASD’s proposal to implement a pilot program pursuant to which certain fully hedged equity option positions would be automatically exempt from established position[1] and exercise[2] limits. On March 18, 1994, the Commission extended the NASD's hedge exemption pilot program through December 31, 1995.[3] On December 29, 1995, the Commission again extended the NASD's hedge exemption pilot program through December 31, 1997.[4] The proposed rule change herein would extend the hedge exemption pilot program for an additional two years, or through December 31, 1999.

The NASD's hedge exemption provides for an automatic exemption from equity option position limits for accounts that have established one of the four most commonly used hedged positions[5] and where each 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

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1 Position limits impose a ceiling on the number of options contracts in each class on the same side of the market, i.e., aggregating long calls and short puts and long puts and short calls, that can be held or written by an investor or group of investors acting in concert. Rule 2860(b)(3)(A) currently provides that equity option position limits are 4,500, 7,500, 10,500, 20,000, and 25,000 contracts, depending on the trading volume and number of outstanding shares of the underlying stock.

2 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 Rule 2860(b)(3).

3 Securities Exchange Act Release No. 34-33783 (March 18, 1994), 59 FR 14229 (March 25, 1994).

4 Securities Exchange Act Release No. 34-36657 (December 29, 1995), 61 FR 434 (January 5, 1996).

5 The four exempted hedge positions are: (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.

stock,[6] or (iii) in the case of an adjusted options contract, hedged by the number of shares represented by the adjusted contract.

Under the NASD's hedge exemption, the largest 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 limit of the underlying security. The exercise limit for options positions established pursuant to the hedge exemption are commensurate with the position limits that may be established pursuant to the hedge exemption. Thus, for example, if the position limit for an option is 25,000 contracts and investor has establishes a position of 75,000 contracts pursuant to the hedge exemption, the investor may exercise all 75,000 contracts during five consecutive business days.

The proposed rule change to extend the effective date of the pilot program is necessary to enable market participants to continue to avail themselves of the hedge exemption and to create parity and consistency with the other options self-regulatory

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[6] The Commission notes that NASD Regulation determines on a case-by-case basis whether an instrument that is being used as the basis for the underlying hedged positions is readily convertible into, or economically equivalent to, the security underlying the corresponding option position. In this regard, NASD Regulation generally finds that an instrument that is not presently convertible into a security, but which will be at a future date, is not a "convertible" security for purposes of the hedge exemption. In addition, NASD Regulation notes that if a convertible security used to hedge an option position is called for redemption by the issuer, the security would have to be converted into the underlying security immediately or the corresponding option position would have to be reduced accordingly.

organizations which have in effect an equity hedge exemption.[7] The proposed rule change extends the effective date until December 13, 1999.

(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 extending the effectiveness of the hedge exemption pilot program may increase 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. Extending the effectiveness also will promote consistency among the rules of the NASD and the other options self-regulatory organizations. The NASD notes that the higher position limits currently available by virtue of the hedge exemption have not resulted in disruptions of the underlying stock market. However, the NASD will continue to monitor the market effects, if any, from the hedge exemption. In addition, the NASD will continue to monitor use of the position limit hedge exemption to ensure that members are complying with all applicable requirements.

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

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)

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 extends the effective date of the hedge exemption pilot program, which has been in place since 1990. The Commission previously extended the effectiveness of the hedge exemption pilot program on an accelerated basis on two prior occasions.[8] NASD Regulations believes that good cause exists to accelerate approval of the proposed rule change because expressly continuing the hedge exemption pilot

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[8] See Securities Act Release No. 43-36657 (December 29, 1995), 61 FR 434 (January 5, 1996) (accelerated approval extending effectiveness of hedge exemption pilot program through December 31, 1997); Securities Act Release No. 34-33783 (March 18, 1994), 59 FR 14229 (March 25, 1994) (accelerated approval extending effectiveness of hedge exemption pilot

program by rule will reduce the potential for confusion about the status of such exemption, which expired on December 31, 1997, and will promote consistency among the options self-regulatory organizations all of which have a similar 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

January 20, 1998

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program through December 31, 1995).

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-98-02)

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

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)(c) of the National Association of Securities Dealers, Inc. ("NASD" or "Association"), to extend, until December 31, 1999, the Association’s pilot program for exemptions from equity option position limits for certain hedged positions (“hedge exemption pilot program”). Below is the text of the proposed rule change. Proposed new language is in italics; 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 paragraph (b)(3)(A)(i) - (v).

c. The Equity Option Hedge Exemption is a pilot program authorized by the Commission through December 31, 199<u>9</u>[7].

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**

On February 9, 1990, the Commission approved the NASD's proposal to implement a pilot program pursuant to which certain fully hedged equity option positions would be automatically exempt from established position[1] and exercise[2] limits. On March 18, 1994, the Commission extended the NASD's hedge exemption pilot program through December 31, 1995.[3] On December 29, 1995, the Commission again extended the NASD's hedge exemption pilot program through December 31, 1997.[4] The proposed rule change herein

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[1] Position limits impose a ceiling on the number of options contracts in each class on the same side of the market, i.e., aggregating long calls and short puts and long puts and short calls, that can be held or written by an investor or group of investors acting in concert. Rule 2860(b)(3)(A) currently provides that equity option position limits are 4,500, 7,500, 10,500, 20,000, and 25,000 contracts, depending on the trading volume and number of outstanding shares of the underlying stock.

[2] 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 Rule 2860(b)(3).

[3] Securities Exchange Act Release No. 34-33783 (March 18, 1994), 59 FR 14229 (March 25, 1994).

[4] Securities Exchange Act Release No. 34-36657 (December 29, 1995), 61 FR 434 (January 5, 1996).

would extend the hedge exemption pilot program for an additional two years, or through December 31, 1999.

The NASD's hedge exemption provides for an automatic exemption from equity option position limits for accounts that have established one of the four most commonly used hedged positions[5] and where each 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,[6] or (iii) in the case of an adjusted options contract, hedged by the number of shares represented by the adjusted contract.

Under the NASD's hedge exemption, the largest 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 limit of the underlying security. The exercise limit for options positions established pursuant to the hedge exemption are commensurate with the position limits that may be established pursuant to the hedge exemption. Thus, for example, if the position limit for an option is 25,000 contracts and investor has establishes a position of 75,000 contracts

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[5] The four exempted hedge positions are: (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.

[6] The Commission notes that NASD Regulation determines on a case-by-case basis whether an instrument that is being used as the basis for the underlying hedged positions is readily convertible into, or economically equivalent to, the security underlying the corresponding option position. In this regard, NASD Regulation generally finds that an instrument that is not presently convertible into a security, but which will be at a future date, is not a "convertible" security for purposes of the hedge exemption. In addition, NASD Regulation notes that if a convertible security used to hedge an option position is called for redemption by the issuer, the security would have to be converted into the underlying security immediately or the corresponding option position would have to be reduced accordingly.

pursuant to the hedge exemption, the investor may exercise all 75,000 contracts during five consecutive business days.

The proposed rule change to extend the effective date of the pilot program is necessary to enable market participants to continue to avail themselves of the hedge exemption and to create parity and consistency with the other options self-regulatory organizations which have in effect an equity hedge exemption.[7] The proposed rule change extends the effective date until December 13, 1999.

(2) **Statutory Basis**

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[8] 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 extending the effectiveness of the hedge exemption pilot program may increase 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. Extending the effectiveness also will promote consistency among the rules of the NASD and the other options self-regulatory organizations. The NASD notes that the higher position limits currently available by virtue of the hedge exemption have not resulted in disruptions of the underlying stock market. However, the NASD will continue to

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

[8] 15 U.S.C. 78f(b)(5).

monitor the market effects, if any, from the hedge exemption. In addition, the NASD will continue to monitor use of the position limit 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. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

NASD Regulation has requested that the Commission find good cause pursuant to Section 19(b)(2) for approving the proposed rule change prior to the 30th day after publication in the Federal Register. The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD and, in particular, the requirements of Section 15A and the rules and regulations thereunder. The Commission finds good cause for approving the proposed rule change prior to the 30th day after the date of publication of notice of filing thereof in that the proposed rule change extends the effective date of the hedge exemption pilot program, which has been in place since 1990. The Commission previously extended the effectiveness of the hedge exemption pilot program on an accelerated basis on two prior occasions.[9] The Commission believes that good cause exists to accelerate approval of the proposed rule change because expressly continuing the hedge exemption pilot program by rule will reduce the potential for confusion about the status of such exemption, which expired on December 31, 1997, and will promote consistency among the options self-regulatory organizations all of which have a similar 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].

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[9] See Securities Act Release No. 43-36657 (December 29, 1995), 61 FR 434 (January 5, 1996) (accelerated approval extending effectiveness of hedge exemption pilot program through December 31, 1997); Securities Act Release No. 34-33783 (March 18, 1994), 59 FR 14229 (March 25, 1994) (accelerated approval extending effectiveness of hedge exemption pilot

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[10] that the proposed rule change be, and hereby is, approved.

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

Jonathan G. Katz
Secretary

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program through December 31, 1995).

[10] 15 U.S.C. 78s(b)(2).

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