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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
Form 19b-4

File No. SR - 2005 - 040
Amendment No.

Proposed Rule Change by National Association of Securities Dealers

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

Initial	Amendment	Withdrawal	Section 19(b)(2)	Section 19(b)(3)(A)	Section 19(b)(3)(B)
☑	☐	☐	☐	☑	☐

Pilot ☑

Extension of Time Period for Commission Action ☐

Date Expires

Rule

☐ 19b-4(f)(1)	☐ 19b-4(f)(4)
☐ 19b-4(f)(2)	☐ 19b-4(f)(5)
☐ 19b-4(f)(3)	☑ 19b-4(f)(6)

Exhibit 2 Sent As Paper Document ☐

Exhibit 3 Sent As Paper Document ☐

Description

Provide a brief description of the proposed rule change (limit 250 characters).

Proposed rule change to amend Rule 2860 to increase certain options position limits for a pilot period and to expand the available equity option hedge exemptions to include “reverse collars.”

Contact Information

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name: James
Last Name: Eastman
Title: Assistant General Counsel
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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Date: 03/30/2005

By: Patrice Gliniecki (Name)

Senior Vice President and Deputy General Counsel (Title)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

PATRICE GLINIECKI,

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

Form 19b-4 Information Add Remove View	The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.
Exhibit 1 - Notice of Proposed Rule Change Add Remove View	The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)
Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications Add Remove View Exhibit Sent As Paper Document ☐	Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.
Exhibit 3 - Form, Report, or Questionnaire Add Remove View Exhibit Sent As Paper Document ☐	Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.
Exhibit 4 - Marked Copies Add Remove View	The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.
Exhibit 5 - Proposed Rule Text Add Remove View	The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.
Partial Amendment Add Remove View	If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

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

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to amend Rule 2860 to increase certain options position limits for a pilot period and to expand the available equity option hedge exemptions to include "reverse collars." Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2800. SPECIAL PRODUCTS

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2860. Options

(a) No Change.

(b) Requirements.

(1) and (2) No Change.

(3) Position Limits

(A) Stock Options—Except in highly unusual circumstances, and with the prior written approval of NASD pursuant to the Rule 9600 Series for good cause shown in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, non-member broker, or non-member dealer, an opening transaction through Nasdaq, the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) 13,500 (or 25,000 during the pilot period from [insert date published by SEC] through September 2, 2005 ("Pilot Period")) 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) 22,500 (or 50,000 during the Pilot Period) 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 22,500 (or 50,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 (or 50,000 during the Pilot Period) option contracts; or

(iii) 31,500 (or 75,000 during the Pilot Period) 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 31,500 (or 75,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 (or 75,000 during the Pilot Period) option contracts; or

(iv) 60,000 (or 200,000 during the Pilot Period) option contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 60,000 (or 200,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 (or 200,000 during the Pilot Period) option contracts; or

(v) 75,000 (or 250,000 during the Pilot Period) option contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 75,000 (or 250,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 (or 250,000 during the Pilot Period) option contracts; or

(vi) No Change.

(vii) Equity Option Hedge Exemptions

a. The following qualified hedge strategies and positions described in subparagraphs 1. through [5] 6. below shall be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs [6] 7. and [7] 8. below in which one of the option components consists of a conventional option, shall be subject to a position limit of five times the established position limits contained in subparagraphs (i) through (vi) above. Hedge strategies and positions in conventional options as described in subparagraphs 1. through [5] 6. below shall be subject to a position limit of five times the established limits contained in subparagraphs (i) through (vi) above. Options positions limits established under this subparagraph shall be separate from limits established in other provisions of this rule.

1. through 3. No Change.

4. Reverse Collars — A long call position accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security

(or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established.

[4.] 5. Collars — A short call position accompanied by a long put position, where the short call expires with the long put, and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

[5] 6. Box Spreads — A long call position accompanied by a short put position with the same strike price and a short call position accompanied by a long put position with a different strike price.

[6] 7. Back-to-Back Options — A listed option position hedged on a one-for-one basis with an over-the-counter (OTC) option position on the same underlying security. The strike price of the listed option position and corresponding OTC

option position must be within one strike price interval of each other and no more than one expiration month apart.

[7] 8. For reverse conversion, conversion, reverse collar and collar strategies set forth above in subparagraphs 2., 3., 4. and 5. [4.], one of the option components can be an OTC option guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account.

b. No Change.

(viii) Conventional Equity Options

a. For purposes of this paragraph (b), standardized equity option 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 option contracts or FLEX Equity Option contracts overlying the same security on the same side of the market. Conventional equity option contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a position limit equal to the greater of:

1. the basic limit of 13,500 (or 25,000 during the Pilot Period) contracts, or

2. any standardized equity options position limit as set forth in paragraphs (b)(3)(A)(ii) through (v) for which the underlying security qualifies or would be able to qualify.

b. In order for a security not subject to standardized equity options trading to qualify for an options position limit of more than 13,500 (or 25,000 during the Pilot Period) contracts, a member must first demonstrate to NASD's Market Regulation Department that the underlying security meets the standards for such higher options position limit and the initial listing standards for standardized options trading.

(B) through (D) No Change.

(4) through (24) No Change.

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2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Governors of NASD ("Board") and authorized for filing with the SEC pursuant to a delegation of authority granted by the Board at its meeting on January 23, 2003, to the General Counsel of NASD Regulatory Policy and Oversight (or his officer designee) ("Delegation of Authority") to file, without further specific Board authorization, administrative, technical, conforming, and non-substantive changes to NASD rules. The Nasdaq Stock Market and NASD Dispute Resolution were provided an opportunity to consult with respect to the proposed rule change pursuant to the Plan of Allocation and Delegation of Functions by NASD to its Subsidiaries. The staff will advise the Board of any action taken pursuant to the Delegation of Authority. No other action by NASD is necessary for the filing of this 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.

NASD has filed the proposed rule change for immediate effectiveness, and has requested that the Commission waive the 5-day pre-filing requirement and the 30-day period for the proposed rule change to become operative, in order to allow NASD's position limits to more quickly conform to those of other self-regulatory organizations ("SROs") that regulate options trading and to maintain parity between the position limits for standardized and conventional options.

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

(a) Purpose

NASD is proposing amendments to its options position and exercise limits in Rule 2860 to conform to similar changes recently approved by the Commission or adopted by other SROs with options rules.[1] The proposed rule change would increase, as

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[1] See Securities Exchange Act Release No. 51322 (March 4, 2005), 70 FR 12260 (March 11, 2005) (SR-PHLX-2005-17); Securities Exchange Act Release No. 51317 (March 3, 2005), 70 FR 12254 (March 11, 2005) (SR-BSE-2005-10); Securities Exchange Act Release No. 51316 (March 3, 2005), 70 FR 12251 (March 11, 2005) (SR-AMEX-2005-029); Securities Exchange Act Release No. 51295 (March 2, 2005), 70 FR 11292 (March 8, 2005) (SR-ISE-2005-14); Securities Exchange Act Release No. 51286 (March 1, 2005), 70 FR 11297 (March 8, 2005) (SR-PCX-2003-55) ("collectively Exchange Notices"); Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010

part of a pilot program ending September 2, 2005 (unless extended) ("Pilot Period"), position limits for both standardized and conventional options.[2] Specifically, standardized and conventional options subject to a position limit of 13,500 contracts would increase to 25,000 contracts; standardized and conventional options subject to a position limit of 22,500 contracts would increase to 50,000 contracts; standardized and conventional options subject to a position limit of 31,500 contracts would increase to 75,000 contracts; standardized and conventional options subject to a position limit of 60,000 contracts would increase to 200,000 contracts; and standardized and conventional options subject to a position limit of 75,000 contracts would increase to 250,000 contracts. Options exercise limits, which are set forth in Rule 2860(b)(4), and which incorporate by reference the position limits in Rule 2860(b)(3), also would increase during the Pilot Period.

(March 1, 2005) (SR-CBOE-2003-30) ("Approval Order") and filers collectively referred to as "Options Exchanges").

2 A "conventional option" is an option contract not issued, or subject to issuance by, The Options Clearing Corporation. NASD Rule 2860(b)(2)(N). Currently, position limits for standardized and conventional options are the same with respect to the same underlying security. The proposed rule change would maintain this parity between standardized and conventional options. NASD has maintained parity between conventional and standardized options since 1999. See Securities Exchange Act Release No. 40932 (January 11, 1999), 64 FR 2930, 2931 (January 19, 1999). Before 1999, position limits on conventional options were three times greater than the limits for standardized options. See Securities Exchange Act Release No. 33746 (June 12, 1998), 63 FR 33746 (June 19, 1998).

The NASD's limits on standardized equity options are applicable only to those members that are not also members of the exchange on which the option is traded; the limits on conventional options are applicable to all NASD members. NASD Rule 2860(b)(1)(A); see also Securities Exchange Act Release No. 40932 (January 11, 1999), 64 FR 2930, 2931 (January 19, 1999).

In addition, the proposed rule change would expand the available equity option hedge exemptions to include "reverse collars." Options positions hedged pursuant to one of the qualified equity option hedge strategies are exempt from position limits for standardized options, and subject to position limits of five times the standardized limits for conventional options. The equity option hedge exemption for a reverse collar applies to a long call position accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established. The addition of the reverse collar equity option hedge exemption is not part of the pilot program and would be permanent.

NASD has proposed increasing the applicable position limits during the Pilot Period because, without such an increase, NASD's position limits would be lower than those of the Options Exchanges during the Pilot Period. This would result, with respect to standardized options, in inconsistent treatment of NASD member firms that are not members of an Options Exchange as well as the customers of such firms.[3] The proposed rule change also is necessary to maintain parity between the option position limits for conventional and standardized equity options as currently reflected in NASD rules.

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[3] See 64 FR at 2931 ("Without such an increase, the NASD's standardized equity options position limits would be lower than those established by the Options Exchanges and would lead to inconsistent treatment as to firms (and customers of such firms) that are NASD members but not members of an options exchange, the category of persons for whom our standardized position limits apply.").

NASD believes that the rationales articulated by the Options Exchanges in their rule filings filed with the SEC apply equally to the proposed rule change.[4] Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. NASD also agrees with the reasoning articulated by the Commission when approving changes to certain position limits in 1999:

> The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set equity option position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market for the underlying security…At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs….[5]

NASD submits that the proposed rule change is consistent with these Commission policies.

Also, as was emphasized by the Options Exchanges, there are financial and other regulatory protections in place to protect the markets from potential manipulations or other dislocations caused by holding or exercising excessive options positions.[6] NASD agrees with the Options Exchanges and also believes that increasing position limits

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4 See generally Exchange Notices and Approval Order.

5 Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842, 1843 (January 12, 1999).

6 See generally Exchange Notices and Approval Order (each of the Options Exchanges asserts that an increase in position limits does not present market manipulation concerns because of a combination of SEC oversight, SRO and member firm surveillance, and net capital, margin, and large position reporting requirements).

during the Pilot Period should aid members in facilitating customer order flow and offsetting the risks that arise with such facilitation.

NASD has filed the proposed rule change for immediate effectiveness, and has requested that the Commission waive the 5-day pre-filing requirement and the 30-day period for the proposed rule change to become operative, in order to allow NASD's position limits to more quickly conform to those of the Options Exchanges and to allow conventional options position limits to maintain parity with position limits for standardized options, during the Pilot Period.

(b) Statutory Basis

NASD 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 NASD'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 proposed rule change is being made to achieve consistency between NASD's options position limits and those published in the Exchange Notices and approved in the Approval Order and thereby avoid inconsistent treatment of NASD member firms that are not members of an Options Exchange as well as the customers of such firms. Additionally, the proposed rule change would maintain parity between the position limits for standardized and conventional options, during the Pilot Period.

4. <u>Self-Regulatory Organization's Statement on Burden on Competition</u>

NASD 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

Not applicable.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3)

The proposed rule change is effective upon filing pursuant to Section 19(b)(3)(A) of the Act[7] and paragraph (f)(6) of Rule 19b-4 thereunder,[8] in that the proposed rule change does not significantly affect the protection of investors or the public interest; does not impose any significant burden on competition and does not become operative for 30 days after filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest. NASD requests that the Commission waive the 5-day pre-filing requirement and the 30-day period for the proposed rule change to become operative, in order to allow NASD's position limits to more quickly conform to those of the Options Exchanges and to maintain parity in the position limits for standardized and conventional options, during the Pilot Period.

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

The proposed rule change is being made to achieve consistency between NASD's options position limits and those published in the Exchange Notices and approved in the Approval Order.

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7 15 U.S.C. 78s(b)(3)(A).

8 17 CFR 240.19b-4(f)(6).

9. Exhibits

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

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-   ; File No. SR-NASD-2005-040)
SELF-REGULATORY ORGANIZATIONS

Proposed Rule Change by National Association of Securities Dealers, Inc.
Relating to Establishing a Pilot Period to Increase Position and Exercise Limits for Equity Options and Establishing a Reverse Collar Hedge Exemption

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")[1] and Rule 19b-4 thereunder,[2] notice is hereby given that on   , the National Association of Securities Dealers, Inc. ("NASD") 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. NASD has designated the proposed rule change as constituting a "non-controversial" rule change under paragraph (f)(6) of Rule 19b-4 under the Act,[3] which renders the proposal effective upon receipt of this filing by the Commission. 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 is proposing to amend Rule 2860 to increase certain options position limits for a pilot period and to expand the available equity option hedge exemptions to include "reverse collars." Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 17 CFR 240.19b-4.

* * * * *

2800. SPECIAL PRODUCTS

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2860. Options

(a) No Change.

(b) Requirements.

(1) and (2) No Change.

(3) Position Limits

(A) Stock Options—Except in highly unusual circumstances, and with the prior written approval of NASD pursuant to the Rule 9600 Series for good cause shown in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, non-member broker, or non-member dealer, an opening transaction through Nasdaq, the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) 13,500 (<u>or 25,000 during the pilot period from [insert date published by SEC] through September 2, 2005 (“Pilot</u>

Period”)) 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) 22,500 (or 50,000 during the Pilot Period) 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 22,500 (or 50,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 (or 50,000 during the Pilot Period) option contracts; or

(iii) 31,500 (or 75,000 during the Pilot Period) 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 31,500 (or 75,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 (or 75,000 during the Pilot Period) option contracts; or

(iv) 60,000 (or 200,000 during the Pilot Period) option contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 60,000 (or 200,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 (or 200,000 during the Pilot Period) option contracts; or

(v) 75,000 (or 250,000 during the Pilot Period) option contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 75,000 (or 250,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 (or 250,000 during the Pilot Period) option contracts; or

(vi) No Change.

(vii) Equity Option Hedge Exemptions

a. The following qualified hedge strategies and positions described in subparagraphs 1. through [5] 6. below shall be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs [6] 7. and [7] 8. below in which one of the option components consists of a conventional option, shall be subject to a position limit of five times the established position limits contained in subparagraphs (i) through (vi) above. Hedge strategies and positions in conventional options as described in subparagraphs 1. through [5] 6. below shall be subject to a position limit of five times the established limits contained in subparagraphs (i) through (vi) above. Options positions limits established under this subparagraph shall be separate from limits established in other provisions of this rule.

1. through 3. No Change.

4. Reverse Collars — A long call position accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established.

[4.] 5. Collars — A short call position accompanied by a long put position, where the short call expires with the long put, and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

[5] 6. Box Spreads — A long call position accompanied by a short put position with the same strike price and a short call position accompanied by a long put position with a different strike price.

[6] 7. Back-to-Back Options — A listed option position hedged on a one-for-one basis with an over-the-counter (OTC) option position on the same underlying security. The strike price of the listed option position and corresponding OTC option position must be within one strike price interval of each other and no more than one expiration month apart.

[7] 8. For reverse conversion, conversion, reverse collar and collar strategies set forth above in subparagraphs 2., 3., 4. and 5. [4.], one of the option components can be an OTC option guaranteed or

endorsed by the firm maintaining the proprietary position or carrying the customer account.

b. No Change.

(viii) Conventional Equity Options

a. For purposes of this paragraph (b), standardized equity option 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 option contracts or FLEX Equity Option contracts overlying the same security on the same side of the market. Conventional equity option contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a position limit equal to the greater of:

1. the basic limit of 13,500 <u>(or 25,000 during the Pilot Period)</u> contracts, or

2. any standardized equity options position limit as set forth in paragraphs (b)(3)(A)(ii) through (v) for which the underlying security qualifies or would be able to qualify.

b. In order for a security not subject to standardized equity options trading to qualify for an options position limit of more than 13,500 (<u>or 25,000 during the Pilot Period)</u> contracts, a member must first demonstrate to

NASD's Market Regulation Department that the underlying security meets the standards for such higher options position limit and the initial listing standards for standardized options trading.

(B) through (D) No Change.

(4) through (24) No Change.

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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 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 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 is proposing amendments to its options position and exercise limits in Rule 2860 to conform to similar changes recently approved by the Commission or adopted by other self-regulatory organizations (“SROs”) with options rules.[4] The proposed rule

[4] See Securities Exchange Act Release No. 51322 (March 4, 2005), 70 FR 12260 (March 11, 2005) (SR-PHLX-2005-17); Securities Exchange Act Release No. 51317 (March 3, 2005), 70 FR 12254 (March 11, 2005) (SR-BSE-2005-10); Securities Exchange Act Release No. 51316 (March 3, 2005), 70 FR 12251 (March 11, 2005) (SR-AMEX-2005-029); Securities Exchange Act Release No. 51295 (March 2, 2005), 70 FR 11292 (March 8, 2005) (SR-ISE-2005-14); Securities Exchange Act Release No. 51286 (March 1, 2005), 70 FR 11297

change would increase, as part of a pilot program ending September 2, 2005 (unless extended) ("Pilot Period"), position limits for both standardized and conventional options.[5] Specifically, standardized and conventional options subject to a position limit of 13,500 contracts would increase to 25,000 contracts; standardized and conventional options subject to a position limit of 22,500 contracts would increase to 50,000 contracts; standardized and conventional options subject to a position limit of 31,500 contracts would increase to 75,000 contracts; standardized and conventional options subject to a position limit of 60,000 contracts would increase to 200,000 contracts; and standardized and conventional options subject to a position limit of 75,000 contracts would increase to 250,000 contracts. Options exercise limits, which are set forth in Rule 2860(b)(4), and which incorporate by reference the position limits in Rule 2860(b)(3), also would increase during the Pilot Period.

(March 8, 2005) (SR-PCX-2003-55) (collectively "Exchange Notices"); Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (SR-CBOE-2003-30) ("Approval Order" and filers collectively referred to as "Options Exchanges").

5 A "conventional option" is an option contract not issued, or subject to issuance by, The Options Clearing Corporation. NASD Rule 2860(b)(2)(N). Currently, position limits for standardized and conventional options are the same with respect to the same underlying security. The proposed rule change would maintain this parity between standardized and conventional options. NASD has maintained parity between conventional and standardized options since 1999. See Securities Exchange Act Release No. 40932 (January 11, 1999), 64 FR 2930, 2931 (January 19, 1999). Before 1999, position limits on conventional options were three times greater than the limits for standardized options. See Securities Exchange Act Release No. 33746 (June 12, 1998), 63 FR 33746 (June 19, 1998).

The NASD's limits on standardized equity options are applicable only to those members that are not also members of the exchange on which the option is traded; the limits on conventional options are applicable to all NASD members. NASD Rule 2860(b)(1)(A); see also Securities Exchange Act Release No. 40932 (January 11, 1999), 64 FR 2930, 2931 (January 19, 1999).

In addition, the proposed rule change would expand the available equity option hedge exemptions to include “reverse collars.” Options positions hedged pursuant to one of the qualified equity option hedge strategies are exempt from position limits for standardized options, and subject to position limits of five times the standardized limits for conventional options. The equity option hedge exemption for a reverse collar applies to a long call position accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established. The addition of the reverse collar equity option hedge exemption is not part of the pilot program and would be permanent.

NASD has proposed increasing the applicable position limits during the Pilot Period because, without such an increase, NASD’s position limits would be lower than those of the Options Exchanges during the Pilot Period. This would result, with respect to standardized options, in inconsistent treatment of NASD member firms that are not members of an Options Exchange as well as the customers of such firms.[6] The proposed rule change also is necessary to maintain parity between the option position limits for conventional and standardized equity options as currently reflected in NASD rules.

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6 See 64 FR at 2931 (“Without such an increase, the NASD’s standardized equity options position limits would be lower than those established by the Options Exchanges and would lead to inconsistent treatment as to firms (and customers of such firms) that are NASD members but not members of an options exchange, the category of persons for whom our standardized position limits apply.”).

NASD believes that the rationales articulated by the Options Exchanges in their rule filings filed with the SEC apply equally to the proposed rule change.[7] Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. NASD also agrees with the reasoning articulated by the Commission when approving changes to certain position limits in 1999:

> The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set equity option position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market for the underlying security…At the same time, the Commission has determined that limits must not be established at levels that are so low as to discourage participation in the options market by institutions and other investors with substantial hedging needs….[8]

NASD submits that the proposed rule change is consistent with these Commission policies.

Also, as was emphasized by the Options Exchanges, there are financial and other regulatory protections in place to protect the markets from potential manipulations or other dislocations caused by holding or exercising excessive options positions.[9] NASD agrees with the Options Exchanges and also believes that increasing position limits

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7 See generally Exchange Notices and Approval Order.

8 Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842, 1843 (January 12, 1999).

9 See generally Exchange Notices and Approval Order (each of the Options Exchanges asserts that an increase in position limits does not present market manipulation concerns because of a combination of SEC oversight, SRO and member firm surveillance, and net capital, margin, and large position reporting requirements).

during the Pilot Period should aid members in facilitating customer order flow and offsetting the risks that arise with such facilitation.

NASD has filed the proposed rule change for immediate effectiveness, and has requested that the Commission waive the 5-day pre-filing requirement and the 30-day period for the proposed rule change to become operative, in order to allow NASD's position limits more quickly to conform to those of the Options Exchanges and allow conventional options position limits to maintain parity with position limits for standardized options.

2. Statutory Basis

NASD 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 NASD'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 proposed rule change is being made to achieve consistency between NASD's options position limits and those published in the Exchange Notices and approved in the Approval Order and thereby avoid inconsistent treatment of NASD member firms that are not members of an Options Exchange as well as the customers of such firms. Additionally, the proposed rule change would maintain parity between the position limits for standardized and conventional options, during the Pilot Period.

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

NASD 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

Because the foregoing proposed rule change does not:

(i) significantly affect the protection of investors or the public interest;

(ii) impose any significant burden on competition; and

(iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act and Rule 19b-4(f)(6) thereunder.

At any time within 60 days of the filing of the proposed rule change, the Commission may summarily abrogate such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/sro.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number NASD-2005-040 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609.

All submissions should refer to File Number SR-NASD-2005-040. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (http://www.sec.gov/rules/sro.shtml). 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, 450 Fifth Street, NW, Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2005-040 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[10]

Margaret H. McFarland
Deputy Secretary

[10] 17 CFR 200.30-3(a)(12).