

OMB APPROVAL

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

File No. SR - 2006 - 007
Amendment No. 1

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) ☐
			Rule		
Pilot ☐	Extension of Time Period for Commission Action ☐	Date Expires 	☐ 19b-4(f)(1) ☐ 19b-4(f)(2) ☐ 19b-4(f)(3)	☐ 19b-4(f)(4) ☐ 19b-4(f)(5) ☐ 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).

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 Kathryn Last Name Moore
Title Assistant General Counsel
E-mail kathryn.moore@nasd.com
Telephone (202) 974-2974 Fax (202) 728-8264

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 09/20/2006

By Gary L. Goldsholle
(Name)

Vice President and Associate 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.

Gary L. Goldsholle, goldshog@nasd.com

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

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

Form 19b-4 Information

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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

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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

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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

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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

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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

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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

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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. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),¹ the National Association of Securities Dealers, Inc. (“NASD”) is filing with the Securities and Exchange Commission (“SEC” or “Commission”) Amendment No. 1 to SR-NASD-2006-007 to amend Rule 2860 to: (a) revise the definition of the term “underlying index” to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; (b) amend the position reporting requirements for certain conventional index options; and (c) allow members to calculate the position limits, in accordance with volume and float criteria specified by the options exchanges, for conventional equity options overlying securities that are part of a designated index (currently the FTSE All-World Index Series). This Amendment No. 1 addresses the comments the Commission received in response to the publication of the proposed rule change in the Federal Register² and proposes amendments responsive to the comments, where appropriate. Below is the text of the proposed rule change.

Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2800. SPECIAL PRODUCTS

* * * * *

2860. Options

(a) No Change.

(b) Requirements

¹ 15 U.S.C. 78s(b)(1).

² See Exchange Act Release No. 53189 (January 30, 2006), 71 FR 6117 (February 6, 2006) (Notice of Filing of SR-NASD-2006-007).

(1) No Change.

(2) Definitions

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

(A)through (M) No Change.

(N) Conventional Index Option — The term “conventional index option” means any options contract not issued, or subject to issuance, by The Options Clearing Corporation that, as of the trade date, overlies a basket or index of securities that:

(i) Underlies a standardized index option; or

(ii) Satisfies the following criteria:

a. The basket or index comprises 9 or more equity securities;

b. No equity security comprises more than 30% of the equity security component of the basket’s or index’s weighting; and

c. Each equity security comprising the basket or index:

1. is a component security in either the Russell 3000 Index or the FTSE All-World Index Series; or

2. has (A) market capitalization of at least \$75 million or, in the case of the lowest weighted

component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, \$50 million; and (B) trading volume for each of the preceding six months of at least one million shares or, in the case of each of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, 500,000 shares.

(N) through (UU) renumbered as (O) through (VV).

(WW) Standardized Index Option — The term “standardized index option” means any options contract issued, or subject to issuance, by The Options Clearing Corporation that is based upon an index.

(VV) through (XX) renumbered as (XX) through (ZZ).

(AAA) Underlying Index — The term “underlying index” means an index underlying a Standardized Index Option or a Conventional Index Option.

(YY) through (ZZ) renumbered as (BBB) through (CCC).

(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 the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) through (vii) No Change.

(viii) Conventional Equity Options

a. No Change.

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.

Provided, however, that for certain securities in an index designated by NASD, a member may claim such higher position limit as permitted in accordance with the

volume and float criteria specified by NASD; provided further, that a member claiming a higher position limit under this subparagraph must notify NASD's Market Regulation Department in writing in such form as may be prescribed by NASD and shall be filed no later than the close of business day on the next business day following the day on which the transaction or transactions requiring such limits occurred; and provided further, that the member must agree to reduce its position in the event that NASD staff determines different position limits should apply.

(B) through (D) No Change.

(4) No Change.

(5) Reporting of Options Positions

(A) (i) a. Conventional Options

Each member shall file or cause to be filed with [the Association]NASD a report with respect to each account in which the member has an interest, each account of a partner, officer, director or employee or such member, and each customer, non-member broker, or non-member dealer account, which has established an aggregate position of 200 or more option contracts (whether long or short) of the put class and the call class on the same side of the market covering the same underlying security or index, combining for purposes of this subparagraph long positions

in put options with short positions in call options and short positions in put options with long positions in call options, provided, however, that such reporting with respect to positions in conventional index options shall apply only to an option that is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option.

b. No Change.

(ii) No Change.

(B) No Change.

(6) through (24) No Change.

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The proposed rule change was approved by the Board of Directors of NASD Regulation, Inc. at its meeting on November 12, 2003, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been 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 NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on November 13, 2003. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to adopt amendments to NASD

Rules without recourse to the membership for approval.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

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

(a) Purpose

On January 23, 2006, NASD filed SR-NASD-2006-007 with the Commission to amend Rule 2860 to: (a) revise the definition of the term “underlying index” to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; and (b) allow members to calculate the position limits, in accordance with volume and float criteria specified by the options exchanges, for conventional equity options overlying securities that are part of a designated index (currently the FTSE All-World Index Series). The purpose of this Amendment No. 1 is to address the comments the Commission received³ in response to the publication of the proposed rule change in the Federal Register⁴ (“Original Proposal”) and to propose amendments responsive to the comments where appropriate.

Amendment to Definition of “Underlying Index”

In this Amendment No. 1, NASD has amended the definition of “conventional index option” set forth in Rule 2860(b)(2)(N) of the Original Proposal. NASD originally

³ Letter from the Securities Industry Association dated May 23, 2006 (“SIA”).

⁴ See Exchange Act Release No. 53189 (January 30, 2006), 71 FR 6117 (February 6, 2006) (Notice of Filing of SR-NASD-2006-007).

proposed that the definition of “conventional index option” include indexes that do not underlie standardized index options but that meet specified criteria. The purpose of the proposed rule change was to exclude from the definition indexes that are so narrowly constructed that they are the economic equivalent of, or have attributes of, an equity option on common stock. The criteria served to prevent the creation of a narrow index to circumvent the position limit requirement, which does not apply to conventional index options.⁵ The originally proposed criteria were based upon the standards in place at the options exchanges for listing narrow-based or industry indexes.⁶

The SIA generally agreed that it is appropriate to define “conventional index option” and base the criteria on standards that are used by options exchanges. However, the SIA suggested revising the criteria set forth in the definition to incorporate standards that will be more easily verifiable by NASD members to reduce operational risks and burdens.

In response to the comments received, NASD has replaced all of the originally proposed criteria in paragraphs (i) through (x) in the Original Proposal with new criteria as set forth in paragraphs (i) and (ii). NASD believes that these criteria will better capture the types of indexes and baskets that underlie conventional index options used by member firms and bring such options within the purview of the rule.

Specifically, revised Rule 2860(b)(2)(N) would provide that a “conventional index option” may overlie a “basket” or an “index” of securities that either (i) “overlies an index that underlies a standardized index option” or (ii) satisfies certain specified

⁵ See NASD Notice to members 94-46 at 256 (June 1994).

⁶ See, e.g., Chicago Board Options Exchange Rule 24.2(b).

criteria (discussed below). As noted by the SIA, the provision in subparagraph (i) would capture the index definitions contained in the options exchange rules that have been previously approved by the Commission.

Revised Rule 2860(b)(2)(N)(ii) would set forth the criteria for a customized basket or index. The criteria are based, in part, on the Commission's definition of an index that is not a "narrow-based security index" under Section 3(a)(55)(C) of the Act. As a threshold matter, the basket or index must contain nine or more equity securities, mirroring Section 3(a)(55)(C)(i)(I). In addition, no equity security may comprise more than 30% of the equity security component of the basket's or index's weighting, similar to Section 3(a)(55)(C)(i)(II). Finally, the criteria also retain the quantitative standards for capitalization and average daily trading volume contained in the Original Proposal items (iii) and (iv). However, in order to reduce the compliance burden for members to monitor capitalization and trading volume of the index components, in the event that an equity security in the basket or index is included in the Russell 3000 Index or the FTSE All-World Index Series, it will not be necessary to measure the capitalization and volume of the components since these indexes are a reasonable surrogate for these quantitative measurements. NASD believes that these criteria impose sufficient parameters on the components of the index to ensure that a qualifying index will not be so narrowly constructed as to be the economic equivalent of an equity option on common stock. Accordingly, NASD has deleted the remainder of the criteria proposed in the Original Proposal.

In addition, revised Rule 2860(b)(2)(N) would provide that the application of the "conventional index option" definition would be determined "as of the trade date" to

ensure that the index is not adversely impacted by subsequent events that could cause it to no longer be in compliance with the rule.

The SIA also suggested revising the definition of “conventional index option” to permit the inclusion of additional securities other than equity securities. NASD believes that it would be appropriate permit the incorporation of other securities into an index that otherwise meets the definition of “conventional index option.” NASD believes that the existing proposed definition of conventional index options permits the inclusion of non-equity securities, and accordingly is not proposing any change to the rule text. Under the proposed rule change, members are able to include other securities to the index and as long as the index continues to satisfy the requirements set forth in the definition of conventional index option, the index will be treated as a “conventional index option” and thus exempt from position limits and reporting requirements.

In its comment letter, the SIA also stated that it believes that the A.M. settlement requirement in subsection (i) of the Original Proposal is not necessary or warranted. The SIA noted that while requiring the underlying index to be A.M. settled for standardized index options makes sense in order to reduce the possibility for market manipulation, the same is not true for conventional index options. The SIA further noted that conventional index options have been regularly traded for years without the A.M. settlement requirement and without causing any disruption to the underlying securities market. Based on this comment and discussions with the SEC staff, NASD has chosen not to include an A.M. settlement requirement as part of the proposed rule change.

The SIA also had comments on the position reporting levels for conventional index options. The SIA suggested exempting conventional index options, other than

conventional index options overlying an index that underlies a standardized index option, from the position reporting requirements set forth in Rule 2860(b)(5). In light of the unique nature of these types of index options, NASD believes the reporting of these unique index options would have limited value since they are not subject to the position or exercise limits. NASD proposes to revise Rule 2860(b)(5) to provide that reporting on conventional index options shall apply only to an option that is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option. NASD is, of course, able to obtain information about conventional index options pursuant to a request under Rule 8210. Thus, eliminating the position reporting requirement will not prevent NASD from accessing this information as needed for its market oversight and enforcement responsibilities.

Finally, the SIA suggested raising the position reporting levels from the current 200 contract reporting threshold and recommends a position reporting threshold of 10,000 contracts for conventional index options. NASD does not believe such a change is appropriate or necessary at this time. However, NASD will consider this issue and subject it to further review and discussion with the other self-regulatory organizations following the approval of the proposed rule change.

Position Limits for Conventional Equity Options Overlying Certain Foreign Securities

There were no comments on the portion of the proposed rule change that addressed the need for members to identify position limits for conventional equity options on securities that do not underlie a standardized equity option. Accordingly, NASD is not proposing any further amendments.

As noted in Item 2 of this filing, NASD will announce the effective date of the

proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁷ which requires, among other things, that NASD's rules 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. NASD believes that amending the definition of "underlying index" will ensure more complete reporting of options positions. NASD also believes that permitting members to calculate position limits for certain foreign securities will enable members to effect options transaction in such securities without unnecessary delay.

4. 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.

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

The Commission published the proposed rule change in the Federal Register on February 6, 2006. The comment period closed on February 27, 2006. The Commission received one comment in response to the Federal Register publication of the proposal. The comments are summarized above.

6. Extension of Time Period for Commission Action

⁷ 15 U.S.C. 78o-3(b)(6).

NASD 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.⁸

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**

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

Exhibit 4. Exhibit 4 shows the full text of the rule change marking changes from the originally filed proposed rule change, with the original language changes shown as if adopted and the new language marked to show additions and deletions.

⁸ 15 U.S.C. 78s(b)(2).

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASD-2006-007)

Self-Regulatory Organizations: National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to Options Rules

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”)³ the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD. 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: (a) revise the definition of the term “underlying index” to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; (b) amend the position reporting requirements for certain conventional index options; and (c) allow members to calculate the position limits, in accordance with volume and float criteria specified by the options exchanges, for conventional equity options overlying securities that are part of a

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ This Amendment No. 1 to SR-NASD-2006-007 amended the rule filing originally filed on January 23, 2006.

designated index (currently the FTSE All-World Index Series). Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

2800. SPECIAL PRODUCTS

* * * * *

2860. Options

(a) No Change.

(b) Requirements

(1) No Change.

(2) Definitions

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

(A) through (M) No Change.

(N) Conventional Index Option — The term “conventional index option” means any options contract not issued, or subject to issuance, by The Options Clearing Corporation that, as of the trade date, overlies a basket or index of securities that:

(i) Underlies a standardized index option; or

(ii) Satisfies the following criteria:

a. The basket or index comprises 9 or more equity securities;

b. No equity security comprises more than 30% of the equity security component of the basket's or index's weighting; and

c. Each equity security comprising the basket or index:

1. is a component security in either the Russell 3000 Index or the FTSE All-World Index Series; or

2. has (A) market capitalization of at least \$75 million or, in the case of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, \$50 million; and (B) trading volume for each of the preceding six months of at least one million shares or, in the case of each of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, 500,000 shares.

(N) through (UU) renumbered as (O) through (VV).

(WW) Standardized Index Option — The term “standardized index option” means any options contract issued, or subject to issuance, by The Options Clearing Corporation that is based upon an index.

(VV) through (XX) renumbered as (XX) through (ZZ).

(AAA) Underlying Index — The term “underlying index” means an index underlying a Standardized Index Option or a Conventional Index Option.

(YY) through (ZZ) renumbered as (BBB) through (CCC).

(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 the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) through (vii) No Change.

(viii) Conventional Equity Options

a. No Change.

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.

Provided, however, that for certain securities in an index designated by NASD, a member may claim such higher position limit as permitted in accordance with the volume and float criteria specified by NASD; provided further, that a member claiming a higher position limit under this subparagraph must notify NASD's Market Regulation Department in writing in such form as may be prescribed by NASD and shall be filed no later than the close of business day on the next business day following the day on which the transaction or transactions requiring such limits occurred; and provided further, that the member must agree to reduce its position in the event that NASD

staff determines different position limits should apply.

(B) through (D) No Change.

(4) No Change.

(5) Reporting of Options Positions

(A) (i) a. Conventional Options

Each member shall file or cause to be filed with [the Association]NASD a report with respect to each account in which the member has an interest, each account of a partner, officer, director or employee or such member, and each customer, non-member broker, or non-member dealer account, which has established an aggregate position of 200 or more option contracts (whether long or short) of the put class and the call class on the same side of the market covering the same underlying security or index, combining for purposes of this subparagraph long positions in put options with short positions in call options and short positions in put options with long positions in call options, provided, however, that such reporting with respect to positions in conventional index options shall apply only to an option that is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option.

b. No Change.

(ii) No Change.

(B) No Change.

(6) through (24) No Change.

* * * * *

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

On January 23, 2006, NASD filed SR-NASD-2006-007 with the Commission to amend Rule 2860 to: (a) revise the definition of the term “underlying index” to include all indexes underlying standardized index options and other indexes that meet certain specified criteria; and (b) allow members to calculate the position limits, in accordance with volume and float criteria specified by the options exchanges, for conventional equity options overlying securities that are part of a designated index (currently the FTSE All-World Index Series). The purpose of this Amendment No. 1 is to address the comments the Commission received⁴ in response to the publication of the proposed rule change in the Federal Register⁵ (“Original Proposal”) and to propose amendments responsive to the comments where appropriate.

⁴ Letter from the Securities Industry Association dated May 23, 2006 (“SIA”).

⁵ See Exchange Act Release No. 53189 (January 30, 2006), 71 FR 6117 (February 6, 2006) (Notice of Filing of SR-NASD-2006-007).

Amendment to Definition of “Underlying Index”

In this Amendment No. 1, NASD has amended the definition of “conventional index option” set forth in Rule 2860(b)(2)(N) of the Original Proposal. NASD originally proposed that the definition of “conventional index option” include indexes that do not underlie standardized index options but that meet specified criteria. The purpose of the proposed rule change was to exclude from the definition indexes that are so narrowly constructed that they are the economic equivalent of, or have attributes of, an equity option on common stock. The criteria served to prevent the creation of a narrow index to circumvent the position limit requirement, which does not apply to conventional index options.⁶ The originally proposed criteria were based upon the standards in place at the options exchanges for listing narrow-based or industry indexes.⁷

The SIA generally agreed that it is appropriate to define “conventional index option” and base the criteria on standards that are used by options exchanges. However, the SIA suggested revising the criteria set forth in the definition to incorporate standards that will be more easily verifiable by NASD members to reduce operational risks and burdens.

In response to the comments received, NASD has replaced all of the originally proposed criteria in paragraphs (i) through (x) in the Original Proposal with new criteria as set forth in paragraphs (i) and (ii). NASD believes that these criteria will better capture the types of indexes and baskets that underlie conventional index options used by member firms and bring such options within the purview of the rule.

Specifically, revised Rule 2860(b)(2)(N) would provide that a “conventional

⁶ See NASD Notice to members 94-46 at 256 (June 1994).

⁷ See, e.g., Chicago Board Options Exchange Rule 24.2(b).

index option” may overlie a “basket” or an “index” of securities that either (i) “overlies an index that underlies a standardized index option” or (ii) satisfies certain specified criteria (discussed below). As noted by the SIA, the provision in subparagraph (i) would capture the index definitions contained in the options exchange rules that have been previously approved by the Commission.

Revised Rule 2860(b)(2)(N)(ii) would set forth the criteria for a customized basket or index. The criteria are based, in part, on the Commission’s definition of an index that is not a “narrow-based security index” under Section 3(a)(55)(C) of the Act. As a threshold matter, the basket or index must contain nine or more equity securities, mirroring Section 3(a)(55)(C)(i)(I). In addition, no equity security may comprise more than 30% of the equity security component of the basket’s or index’s weighting, similar to Section 3(a)(55)(C)(i)(II). Finally, the criteria also retain the quantitative standards for capitalization and average daily trading volume contained in the Original Proposal items (iii) and (iv). However, in order to reduce the compliance burden for members to monitor capitalization and trading volume of the index components, in the event that an equity security in the basket or index is included in the Russell 3000 Index or the FTSE All-World Index Series, it will not be necessary to measure the capitalization and volume of the components since these indexes are a reasonable surrogate for these quantitative measurements. NASD believes that these criteria impose sufficient parameters on the components of the index to ensure that a qualifying index will not be so narrowly constructed as to be the economic equivalent of an equity option on common stock. Accordingly, NASD has deleted the remainder of the criteria proposed in the Original Proposal.

In addition, revised Rule 2860(b)(2)(N) would provide that the application of the “conventional index option” definition would be determined “as of the trade date” to ensure that the index is not adversely impacted by subsequent events that could cause it to no longer be in compliance with the rule.

The SIA also suggested revising the definition of “conventional index option” to permit the inclusion of additional securities other than equity securities. NASD believes that it would be appropriate permit the incorporation of other securities into an index that otherwise meets the definition of “conventional index option.” NASD believes that the existing proposed definition of conventional index options permits the inclusion of non-equity securities, and accordingly is not proposing any change to the rule text. Under the proposed rule change, members are able to include other securities to the index and as long as the index continues to satisfy the requirements set forth in the definition of conventional index option, the index will be treated as a “conventional index option” and thus exempt from position limits and reporting requirements.

In its comment letter, the SIA also stated that it believes that the A.M. settlement requirement in subsection (i) of the Original Proposal is not necessary or warranted. The SIA noted that while requiring the underlying index to be A.M. settled for standardized index options makes sense in order to reduce the possibility for market manipulation, the same is not true for conventional index options. The SIA further noted that conventional index options have been regularly traded for years without the A.M. settlement requirement and without causing any disruption to the underlying securities market. Based on this comment and discussions with the SEC staff, NASD has chosen not to include an A.M. settlement requirement as part of the proposed rule change.

The SIA also had comments on the position reporting levels for conventional index options. The SIA suggested exempting conventional index options, other than conventional index options overlying an index that underlies a standardized index option, from the position reporting requirements set forth in Rule 2860(b)(5). In light of the unique nature of these types of index options, NASD believes the reporting of these unique index options would have limited value since they are not subject to the position or exercise limits. NASD proposes to revise Rule 2860(b)(5) to provide that reporting on conventional index options shall apply only to an option that is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option. NASD is, of course, able to obtain information about conventional index options pursuant to a request under Rule 8210. Thus, eliminating the position reporting requirement will not prevent NASD from accessing this information as needed for its market oversight and enforcement responsibilities.

Finally, the SIA suggested raising the position reporting levels from the current 200 contract reporting threshold and recommends a position reporting threshold of 10,000 contracts for conventional index options. NASD does not believe such a change is appropriate or necessary at this time. However, NASD will consider this issue and subject it to further review and discussion with the other self-regulatory organizations following the approval of the proposed rule change.

Position Limits for Conventional Equity Options Overlying Certain Foreign Securities

There were no comments on the portion of the proposed rule change that addressed the need for members to identify position limits for conventional equity options on securities that do not underlie a standardized equity option. Accordingly,

NASD is not proposing any further amendments.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

2. Statutory Basis

NASD 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 NASD's rules 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. NASD believes that amending the definition of "underlying index" will ensure more complete reporting of options positions. NASD also believes that permitting members to calculate position limits for certain foreign securities will enable members to effect options transaction in such securities without unnecessary delay.

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.

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

The Commission published the proposed rule change in the Federal Register on February 6, 2006. The comment period closed on February 27, 2006. The Commission

⁸ 15 U.S.C. 78o-3(b)(6).

received one comment in response to the Federal Register publication of the proposal.

The comments are summarized above.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register 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.

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 SR-NASD-2006-007 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASD-2006-007. 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. 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 File Number SR-NASD-2006-007 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.⁹

Nancy M. Morris

Secretary

⁹ 17 CFR 200.30-3(a)(12).

EXHIBIT 4

New text is underlined; deleted text is in brackets

2860. Options

(a) No Change.

(b) Requirements

(1) No Change.

(2) Definitions

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

(A)through (M) No Change.

(N) Conventional Index Option — The term “conventional index option” means any options contract not issued, or subject to issuance, by The Options Clearing Corporation that, as of the trade date, overlies a basket or index of securities that[is based upon an index]:

(i) [The options are designated as A.M.-settled index options;]Underlies a standardized index option; or

(ii) [The index is capitalization-weighted, price-weighted, equal dollar-weighted, or modified capitalization-weighted, and consists of ten or more component securities;]Satisfies the following criteria:

a. The basket or index comprises 9 or more equity securities;

b. No equity security comprises more than 30% of

the equity security component of the basket's or index's weighting; and

c. Each equity security comprising the basket or index:

1. is a component security in either the Russell 3000 Index or the FTSE All-World Index Series; or

2. has (A) market capitalization of at least \$75 million or, in the case of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, \$50 million; and (B) trading volume for each of the preceding six months of at least one million shares or, in the case of each of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, 500,000 shares.

[(iii) Each component security has a market capitalization of at least \$75 million, except that for each of the lowest weighted component securities in the index that in the aggregate account for no more than 10% of the weight of the index, the market capitalization is at least \$50 million;]

[(iv) Trading volume of each component security has been at least one million shares for each of the last six months, except that for each of the lowest weighted component securities in the index that in the aggregate account for no more than 10% of the weight of the index, trading volume has been at least 500,000 shares for each of the last six months;]

[(v) In a capitalization-weighted index or modified capitalization-weighted index, the lesser of the five highest weighted component securities in the index or the highest weighted component securities in the index that in the aggregate represent at least 30% of the total number of component securities in the index each have had an average monthly trading volume of at least 2,000,000 shares over the past six months;]

[(vi) No single component security represents more than 25% of the weight of the index, and the five highest weighted component securities in the index do not in the aggregate account for more than 50% (60% for an index consisting of fewer than 25 component securities) of the weight of the index;]

[(vii) All component securities are “NMS securities” as defined in Section 240.600;]

[(viii) Non-U.S. component securities (stocks or ADRs) that are not subject to comprehensive surveillance agreements do

not in the aggregate represent more than 20% of the weight of the index;]

[(ix) An equal dollar-weighted index will be rebalanced at least once every calendar quarter; and]

[(x) If an underlying index is maintained by a broker-dealer, the index is calculated by a third party who is not a broker-dealer, and the broker-dealer has erected a “Chinese Wall” around its personnel who have access to information concerning changes in and adjustments to the index.]

(N) through [(XX) renumbered as (O) through (YY)](UU)
renumbered as (O) through (VV).

[(ZZ)](WW) Standardized Index Option — The term “standardized index option” means any options contract issued, or subject to issuance, by The Options Clearing Corporation that is based upon an index.

[(YY) through (AAA) renumbered as (AAA) through (CCC)](VV)
through (XX) renumbered as (XX) through (ZZ).

[(DDD)](AAA) Underlying Index — The term “underlying index” means an index underlying a Standardized Index Option or a Conventional Index Option.

[(CCC) through (DDD) renumbered as (EEE) through (FFF)](YY)
through (ZZ) renumbered as (BBB) through (CCC).

(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 the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) through (vii) No Change.

(viii) Conventional Equity Options

a. No Change.

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) contract, 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.

Provided, however, that for certain securities in an index designated by NASD, a member may claim such higher position limit as permitted in accordance with the volume and float criteria specified by NASD; provided further, that a member claiming a higher position limit under this subparagraph must notify NASD's Market Regulation Department in writing in such form as may be prescribed by NASD and shall be filed no later than the close of business day on the next business day following the day on which the transaction or transactions requiring such limits occurred; and provided further, that the member must agree to reduce its position in the event that NASD staff determines different position limits should apply.

(B) through (D) No Change.

(4) No Change.

(5) Reporting of Options Positions

(A) (i) a. Conventional Options

Each member shall file or cause to be filed with [the Association]NASD a report with respect to each account in which the member has an interest, each account of a partner, officer, director or employee or such member, and each customer, non-member broker, or non-member dealer account, which has

established an aggregate position of 200 or more option contracts (whether long or short) of the put class and the call class on the same side of the market covering the same underlying security or index, combining for purposes of this subparagraph long positions in put options with short positions in call options and short positions in put options with long positions in call options, provided, however, that such reporting with respect to positions in conventional index options shall apply only to an option that is based on an index that underlies, or is substantially similar to an index that underlies, a standardized index option.

b. No Change.

(ii) No Change.

(B) No Change.

(6) through (24) No Change.