

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50539; File No. SR-NASD-2004-153)

October 14, 2004

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to a Conditional Exemption from Stock Option Position Limits for OTC Derivatives Dealers

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 12, 2004, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“Commission”) 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 NASD Rule 2860 to provide an exemption from stock options position limits for OTC Derivatives Dealers provided that certain conditions have been satisfied. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

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**2800. SPECIAL PRODUCTS**

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**2860. Options**

(a) No Change.

**(b) Requirements**

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

(1) No Change.

**(2) Definitions**

(A) through (Q) No Change.

(R) Delta Neutral—The term “delta neutral” describes a stock options position that has been hedged, in accordance with an SEC-approved pricing model, with a portfolio of instruments relating to the same underlying stock to offset the risk that the value of the options position will change with changes in the price of the stock underlying the options position.

Current (R) through (FF) Renumbered as (S) through (GG).

(HH) Net Delta—The term “net delta” means the number of shares that must be maintained (either long or short) to offset the risk that the value of a stock options position will change with changes in the price of the stock underlying the options position.

Current (GG) through (BBB) Renumbered as (II) through (DDD).

**(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) through (vi) No Change.

(vii) Equity Options Hedge Exemptions

a. No Change.

b. Delta Hedging Exemption for OTC Derivatives Dealer

A stock options position of an OTC Derivatives Dealer

(as that term is defined in Rule 3b-12 under the Act)

affiliated with a member, in standardized or

conventional options that is delta neutral, shall be

exempt from position limits under this rule if the

following conditions are satisfied:

1. The member has obtained a written

representation from its affiliated OTC

Derivatives Dealer that such entity is hedging its

stock options positions in accordance with its

internal risk management control systems and

pricing models approved by the SEC pursuant to

Rules 15c3-1(a)(5) and 15c3-1f under the Act, and that if it ceases to hedge stock options positions in accordance with such systems and models, that it will provide immediate written notice to the member.

2. The member must report in accordance with paragraph (b)(5), all stock options positions (including those that are delta neutral) of 200 or more contracts (whether long or short) on the same side of the market covering the same underlying stock that are effected by the member.

3. Any stock options position of an OTC Derivatives Dealer that is not delta neutral shall be subject to position limits in accordance with this section (subject, however, to the availability of other exemptions). For these purposes, only the option contract equivalent of the net delta of such positions is subject to position limits. The options contract equivalent of the net delta is the net delta divided by 100.

(viii) No Change.<sup>3</sup>

(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 had 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

Over the past several years, NASD has increased in absolute terms the size of the options position and exercise limits as well as the size and scope of available exemptions for “hedged” positions.<sup>4</sup> These increases, however, have generally required a one-to-one hedge (e.g., one

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<sup>3</sup> Reference to subparagraph (b)(3)(viii) as unchanged was added pursuant to telephone conversation between Gary Goldsholle, Office of General Counsel, Regulatory Policy and Oversight, NASD, and Ira Brandriss, Division of Market Regulation, Commission, on October 14, 2004.

<sup>4</sup> See Securities Exchange Act Release No. 47307 (February 3, 2003), 68 FR 6977 (February 11, 2003) (SR-NASD-2002-134); Securities Exchange Act Release No. 40932 (Jan. 11, 1999), 64 FR 2930 (January 19, 1999) (SR-NASD-98-92); Securities Exchange Act Release No. 40087 (June 12, 1998), 63 FR 33746 (June 19, 1998) (SR-NASD-98-23); Securities Exchange Act Release No. 39771 (March 19, 1998), 63 FR 14743 (March 26, 1998) (SR-NASD-98-15).

stock option contract must be hedged by one-hundred shares of stock). In practice, however, many firms and customers do not hedge their options positions in this way. Rather, these firms engage in what is known as “delta hedging,” which varies the number of shares of stock used to hedge an options position based upon the relative sensitivity of the value of the option contract to a change in the price of the underlying stock.<sup>5</sup> Delta hedging is a widely accepted risk management tool.

In 1998, the Commission approved rules allowing U.S. securities firms to establish a separately capitalized entity to engage in dealer activities in eligible over-the-counter (“OTC”) derivative instruments.<sup>6</sup> This separately capitalized entity, known as an OTC Derivatives Dealer, receives preferential capital treatment and is exempt from self-regulatory organization (“SRO”) membership. In general, however, most transactions of an OTC Derivatives Dealer (including stock options transactions) must be effected through its fully regulated broker-dealer affiliate, except to the extent otherwise permitted by Rule 15a-1 under the Act.<sup>7</sup> Thus, SRO rules, including stock options position and exercise limits, continue to apply to transactions where a member must effect the transaction between the OTC Derivatives Dealer and the counterparty. As a consequence, the application of these position and exercise limits often deters parties from entering into transactions they otherwise would seek to conduct with an OTC Derivatives Dealer in the absence of such limits. Indeed, the Commission recognized this issue at the time it

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<sup>5</sup> For example, an option with a delta of .5 will move \$0.50 for every \$1.00 move in the underlying stock.

<sup>6</sup> Securities Exchange Act Release No. 40594 (Oct. 23, 1998), 63 FR 59362 (Nov. 3, 1998) (SEC File No. S7-30-97)(“OTC Derivatives Dealer release”).

<sup>7</sup> 17 CFR 240.15a-1.

approved rules applicable to OTC Derivatives Dealers.<sup>8</sup> Specifically, the Commission encouraged NASD to revise its rules to recognize as “hedged” those option positions of an OTC Derivatives Dealer that are hedged on a “delta neutral basis” (i.e., the position is delta neutral or fully hedged with regard to the risk that the price of the stock underlying the options position might change).<sup>9</sup>

In June 2003, NASD received a request on behalf of several member firms affiliated with OTC Derivatives Dealers to amend its rule imposing stock options position and exercise limits so that it applied only to a stock options position’s net delta.<sup>10</sup>

NASD believes that the rigor of the OTC Derivatives Dealer approval process and the ongoing oversight by the Commission staff provides an appropriate basis for exempting delta neutral positions in stock options at such entities from position limits. The proposed rule change would exempt from NASD Rule 2860 delta neutral stock options positions of an OTC Derivatives Dealer and would provide that only the option contract equivalent of the net delta of

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<sup>8</sup> OTC Derivatives Dealer release, supra note 6, at 63 FR 59380.

<sup>9</sup> Id.

<sup>10</sup> The proposed rule change does not expressly amend NASD’s options exercise limits in NASD Rule 2860(b)(4) because such exercise limits apply only to the extent NASD Rule 2860(b)(3) imposes position limits. Thus, as delta neutral positions of an OTC Derivatives Dealer would be exempt from position limits under the proposed rule change, such positions also would be exempt from exercise limits. See NASD Notice to Members 94-46 at 2 (“... exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise ... only the number of options contracts set forth as the applicable position limit for those options classes.”). Similarly, for positions held by an OTC Derivatives Dealer that are not delta neutral, only the option contract equivalent of the net delta of such positions would be subject to exercise limits.

a stock options position is subject to position limits provided that the member satisfies three conditions.

The first condition would require a member to receive a written representation from its affiliated OTC Derivatives Dealer stating that the OTC Derivatives Dealer is hedging its stock options positions in accordance with risk management and pricing models approved by the Commission. This written representation would enable NASD to identify those firms that will be relying on the delta hedging exemption on behalf of their OTC Derivatives Dealer affiliates and would be required to be maintained in accordance with the recordkeeping provisions of NASD Rule 3110.

The second condition would require that the member must report stock options positions of the OTC Derivatives Dealer, including those that are delta neutral, in accordance with NASD Rule 2860(b)(5). These reports would inform NASD of the OTC Derivatives Dealer's aggregate stock options positions and permit NASD to conduct surveillance for market manipulation, insider trading, and other trading abuses.

The third condition would provide that any stock options position that is not delta neutral must remain subject to position and, by extension, exercise limits (subject, however, to the availability of other exemptions). An OTC Derivatives Dealer generally employs delta hedging as part of its risk management program, but it is nevertheless possible that an OTC Derivatives Dealer may maintain some positions that are not fully hedged, so long as the entity as a whole meets the conditions imposed by the Commission. In such cases, only the option contract equivalent of the "net delta" of any such stock options positions, which is the net delta divided by 100, would be subject to position limits. This calculation of an options contract equivalent conforms to existing NASD Rule 2860(b)(2)(JJ), which provides that, for purposes of



subparagraphs (3) through (12) of NASD Rule 2860(b), a stock option overlying more or less than 100 shares “shall be deemed to constitute as many option contracts as that other number of shares divided by 100 (e.g., an option to buy or sell five hundred shares of common stocks shall be considered as five option contracts).”

It is important to note that, for purposes of the proposed rule change, only financial instruments relating to the stock underlying a stock options position could be included in any determination of a stock options position’s net delta or whether the stock options position is delta neutral. For example, warrants granting the right to purchase Microsoft stock might be used to offset the risk associated with a position in Microsoft puts granting the holder the right to sell Microsoft stock. However, for purposes of the proposed rule change, a position in Microsoft calls granting the holder the right to purchase Microsoft stock may not be hedged by puts (or any other financial instrument) overlying any security other than Microsoft stock.

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 no later than 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,<sup>11</sup> which requires, among other things, that NASD 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. NASD believes

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<sup>11</sup> 15 U.S.C. 78q-3(b)(6).

that it is appropriate, subject to certain conditions, to exempt stock options positions of OTC Derivatives Dealers from position limits and require that only the option contract equivalent of the net delta of a stock options position be subject to position limits. Moreover, NASD's proposed rule change would implement an approach that the Commission encouraged NASD to adopt at the time the Commission approved the regulatory model for OTC Derivatives Dealers.<sup>12</sup>

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

NASD does not believe that the proposed rule change could 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

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 NASD consents, the Commission will:

- (A) by order approve such proposed rule change; or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

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<sup>12</sup> OTC Derivatives Dealer release, supra note 6, at 63 FR 59380.

#### 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](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2004-153 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-2004-153. 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 Section, 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 publicly available. All submissions should refer to File Number SR-NASD-2004-153 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.<sup>13</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>13</sup> 17 CFR 200.30-3(a)(12).