

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-56916; File No. SR-NASD-2007-044)

December 6, 2007

Self-Regulatory Organizations; National Association of Securities Dealers, Inc. (n/k/a Financial Industry Regulatory Authority, Inc.); Order Granting Approval of Proposed Rule Change, as Modified by Amendment No. 1 Thereto, to Expand the Class of Entities Permitted to Use the Delta Hedging Exemption from Equity Options Position Limits

On June 29, 2007, the National Association of Securities Dealers, Inc. (“NASD”) (n/k/a Financial Industry Regulatory Authority, Inc.) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² a proposed rule change to amend Rule 2860 to expand the class of entities permitted to use the delta hedging exemption from equity options position limits.³ The Commission published the proposed rule change for comment in the Federal Register on August 13, 2007.⁴ On October 15, 2007, FINRA filed Amendment No. 1 to the

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ On July 26, 2007, the Commission approved a proposed rule change filed by NASD to amend NASD’s Certificate of Incorporation to reflect its name change to Financial Industry Regulatory Authority Inc., or FINRA, in connection with the consolidation of the member firm regulatory functions of NASD and NYSE Regulation, Inc. See Securities Exchange Act Release No. 56146 (July 26, 2007), 72 FR 42190 (August 1, 2007).

⁴ See Securities Exchange Act Release No. 56207 (August 6, 2007), 72 FR 45284.

proposed rule change.⁵ The Commission received one comment letter on the proposed rule change.⁶ This order approves the proposed rule change as modified by Amendment No. 1.

In 2004, the Commission approved amendments to Rule 2860 that provide a delta hedging exemption from stock options position and exercise limits⁷ for positions held by affiliates of FINRA members approved by the Commission as “OTC derivatives dealers.”⁸

Under the proposal, FINRA would expand eligibility for its delta hedging exemption beyond OTC derivatives dealers by allowing members and certain non-member affiliates⁹ to rely on this exemption if its position in standardized and/or conventional equity options is delta neutral under

⁵ In Amendment No. 1, FINRA made technical revisions to the proposal. This is a technical amendment and is not subject to notice and comment. In Amendment No. 1, FINRA noted that the effective date of the proposal will be February 1, 2008, or such later date as may be necessary to ensure completion of the required technology changes by the Options Clearing Corporation and the Securities Industry Automation Corporation.

⁶ See letter to Nancy M. Morris, Secretary, Commission, from John R. Vitha, Esq., Chairman, Derivative Products Committee, Securities Industry and Financial Markets Association, dated September 25, 2007. The commenter supported the proposed rule change.

⁷ The proposed rule change does not expressly amend FINRA’s options exercise limits in Rule 2860(b)(4) because such exercise limits apply only to the extent Rule 2860(b)(3) imposes position limits. Thus, as delta neutral positions 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 (June 1994) 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 that are not delta neutral, only the option contract equivalent of the net delta of such positions would be subject to exercise limits.

⁸ See Securities Exchange Act Release No. 50748 (November 29, 2004), 69 FR 70485 (December 6, 2004) (SR-NASD-2004-153).

⁹ The Commission notes that only those non-member affiliates identified in the definition of “Permitted Pricing Model” would be eligible to rely on the delta hedging exemption. See *infra* note 10.

a “Permitted Pricing Model.”¹⁰ The options contract equivalent of the net delta¹¹ of a hedged options position still would be subject to the position limits in Rule 2860 (subject to the availability of any other position limit exemptions).¹² A member that intends to employ, or whose non-member affiliate intends to employ, this exemption would be required to provide a written certification to FINRA stating that the member and/or its affiliate will use a Permitted Pricing Model, and that if an affiliate ceases to hedge stock options positions in accordance with such systems and models, it will provide immediate written notice to the member.¹³ Furthermore, any member or designated aggregation unit would be required to report any aggregate position of 200 or more contracts on the same side of the market and the options

¹⁰ “Permitted Pricing Model” for purposes of this exemption would be a pricing model used by: (1) a member or its affiliate subject to consolidated supervision by the Commission pursuant to Appendix E of Rule 15c3-1 under the Act (*i.e.*, a consolidated supervised entity or “CSE”); (2) a financial holding company (“FHC”) or a company treated as an FHC under the Bank Holding Company Act of 1956, or its affiliate subject to consolidated holding company group supervision; (3) a Commission registered OTC derivatives dealer; (4) a national bank under the National Bank Act; and (5) a member, or non-member affiliate (that is part of a CSE or FHC), using a pricing model maintained and operated by the Options Clearing Corporation. See proposed Rule 2860(b)(3)(A)(vii)(b)(1).

¹¹ “Net delta” would be defined to mean “the number of shares that must be maintained (either long or short) to offset the risk that the value of an equity options position will change with incremental changes in the price of the security underlying the options position.” See proposed changes to Rule 2860(b)(2)(GG).

“Options Contract Equivalent of the Net Delta” would be defined to mean the net delta divided by the number of shares underlying the options contract. See proposed Rule 2860(b)(2)(LL).

¹² See proposed Rule 2860(b)(3)(A)(vii)(b). The Commission notes that Rule 2860(b)(3)(A)(vii) provides for multiple, independent hedge exemptions. Of course, to the extent that a position is used to hedge for the purpose of one exemption from position limit requirements, such as the delta hedge exemption, such position cannot be used to take advantage of another exemption from position limit requirements.

¹³ See proposed Rule 2860(b)(3)(A)(vii)(b)(3).

contract equivalent of the net delta of a position representing 200 or more contracts.¹⁴ In addition, the options positions of a non-member relying on this exemption would be required to be carried by a member with which it is affiliated.¹⁵

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder that are applicable to a national securities association.¹⁶ In particular, the Commission believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act,¹⁷ which requires, among other things, that FINRA rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. The Commission has previously stated its support for recognizing options positions hedged on a delta neutral basis as properly exempted from position limits.¹⁸

¹⁴ See proposed Rule 2860(b)(3)(A)(vii)(b)(4).

¹⁵ See proposed Rule 2860(b)(3)(A)(vii)(b)(3).

¹⁶ In approving this rule, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

¹⁷ 15 U.S.C. 78o-3(b)(6).

¹⁸ See Securities Exchange Act Release No. 40594 (October 23, 1998), 63 FR 59362, 59380 (November 3, 1998) (File No. S7-30-97) (adopting rules relating to OTC derivatives dealers).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,¹⁹ that the proposed rule change (SR-NASD-2007-044), as modified by Amendment No. 1, be, and it hereby is, approved.

For the Commission, by the Division of Trading and Markets pursuant to delegated authority.²⁰

Florence E. Harmon
Deputy Secretary

¹⁹ 15 U.S.C. 78s(b)(2).

²⁰ 17 CFR 200.30-3(a)(12).