

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-50748; File No. SR-NASD-2004-153)

November 29, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change by the National Association of Securities Dealers, Inc. to Provide a Delta Hedge Exemption from Stock Option Position Limits for OTC Derivatives Dealers Affiliated with NASD Member Firms When Certain Conditions Are Satisfied

On October 12, 2004, the National Association of Securities Dealers, Inc. (“NASD”) submitted to the Securities and Exchange Commission (“Commission”), 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> a proposed rule change to amend its Rule 2860(b) to provide a delta hedging exemption from stock option position limits for OTC Derivatives Dealers affiliated with NASD member firms when certain conditions are satisfied.<sup>3</sup> The Commission published the proposed rule change for comment in the Federal Register on October 21, 2004.<sup>4</sup> The Commission received no comments on the proposed rule change.

Under the proposal, a stock option position of an OTC Derivatives Dealer that is delta neutral<sup>5</sup> would be exempt from position limits, provided that, among other things, the NASD

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

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

<sup>3</sup> The proposal relates to options positions of an “OTC Derivatives Dealer” as that term is defined in Rule 3b-12 under the Act. See 17 CFR 240.3b-12.

<sup>4</sup> Securities Exchange Act Release No. 50539 (October 14, 2004), 69 FR 61884 (October 21, 2004).

<sup>5</sup> The term “delta neutral” as defined in the proposed rule change describes a stock options position that has been hedged, in accordance with a Commission-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.

member with which the OTC Derivatives Dealer is affiliated has received a written representation from the OTC Derivatives Dealer stating that it is hedging its stock options positions in accordance with its internal risk management control and pricing models approved by the Commission. Any stock options position of an OTC Derivatives Dealer that is not delta neutral would remain subject to position limits.<sup>6</sup>

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.<sup>7</sup> In particular, the Commission believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act,<sup>8</sup> which requires, among other things, that NASD 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.<sup>9</sup>

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<sup>6</sup> See proposed NASD Rule 2860(b)(3)(A)(vii)(b)(3). The Commission notes that NASD 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.

<sup>7</sup> 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).

<sup>8</sup> 15 U.S.C. 78o-3(b)(6).

<sup>9</sup> Securities Exchange Act Release No. 40594 (October 23, 1998), 63 FR 59362, 59380 (November 3, 1998) (adopting rules relating to OTC Derivatives Dealers).

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>10</sup> that the proposed rule change (SR-NASD-2004-153) be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>11</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>10</sup> 15 U.S.C. 78s(b)(2).

<sup>11</sup> 17 CFR 200.30-3(a)(12).