

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-51520; File No. SR-NASD-2005-040)

April 11, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change 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 March 30, 2005, 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 and II below, which Items have been prepared by NASD. NASD has filed the proposal as a “non-controversial” rule change pursuant to Section 19(b)(3)(A) of the Act³ and Rule 19b-4(f)(6) thereunder,⁴ which renders it effective upon filing with 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 NASD 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.” The text of the proposed rule change is available on NASD’s Web site (<http://www.nasd.com>), at NASD’s Office of the Secretary, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 15 U.S.C. 78s(b)(3)(A).

⁴ 17 CFR 240.19b-4(f)(6).

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 NASD Rule 2860 to conform to similar changes recently approved by the Commission or adopted by other self-regulatory organizations ("SROs") with options rules.⁵ The proposed rule change would increase, as part of a pilot program ending September 2, 2005 (unless extended) ("Pilot Period"),

⁵ 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 (March 1, 2005) (SR-CBOE-2003-30) ("Approval Order" and filers collectively referred to as "Options Exchanges").

position limits for both standardized and conventional options.⁶ 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 NASD Rule 2860(b)(4), and which incorporate by reference the position limits in NASD Rule 2860(b)(3), also would increase during the Pilot Period.

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

⁶ 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 (January 19, 1999) (SR-NASD-98-92). Before 1999, position limits on conventional options were three times greater than the limits for standardized options. See Securities Exchange Act Release No. 40087 (June 12, 1998), 63 FR 33746 (June 19, 1998) (SR-NASD-98-23).

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 (January 19, 1999) (SR-NASD-98-92).

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.⁷ 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.

NASD believes that the rationales articulated by the Options Exchanges in their rule filings filed with the Commission apply equally to the proposed rule change.⁸ 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:

⁷ See Securities Exchange Act Release No. 40932 (January 11, 1999), 64 FR 2930, 2931 (January 19, 1999) (SR-NASD-98-92) (“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.”).

⁸ See generally Exchange Notices and Approval Order.

[T]he 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....⁹

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.¹⁰ NASD agrees with the Options Exchanges and also believes that increasing position limits 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.

⁹ Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842, 1843 (January 12, 1999) (File Nos. SR-CBOE-98-25; SR-Amex-98-22; SR-PCX-98-33; SR-Phlx-98-36).

¹⁰ 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 Commission oversight, SRO and member firm surveillance, and net capital, margin, and large position reporting requirements).

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹¹ 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. In addition, 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

The proposed rule change has been designated by NASD as a "non-controversial" rule change pursuant to Section 19(b)(3)(A) of the Act¹² and subparagraph (f)(6) of Rule 19b-4 thereunder.¹³

¹¹ 15 U.S.C. 78o-3(b)(6).

¹² 15 U.S.C. 78s(b)(3)(A).

¹³ 17 CFR 240.19b-4(f)(6).

The foregoing rule change: (1) does not significantly affect the protection of investors or the public interest, (2) does not impose any significant burden on competition, and (3) by its terms does not become operative for 30 days after the date of this filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest. Consequently, the proposed rule change has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁴ and Rule 19b-4(f)(6) thereunder.¹⁵

Pursuant to Rule 19b-4(f)(6)(iii), a proposed “non-controversial” rule change does not become operative for 30 days after the date of filing, or such shorter time as the Commission may designate, if consistent with the protection of investors and the public interest, and NASD gave the Commission written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission.¹⁶ NASD has requested that the Commission waive the five-day pre-filing notice requirement and the 30-day operative delay. The Commission has determined that it is consistent with the protection of investors and the public interest to waive the five-day pre-filing notice requirement and the 30-day operative delay.¹⁷ Waiving the pre-filing requirement and accelerating the operative date will allow NASD to more quickly conform its position and exercise limits and equity hedge exemption provisions, as described above, with those of the Options Exchanges.

¹⁴ 15 U.S.C. 78s(b)(3)(A).

¹⁵ 17 CFR 240.19b-4(f)(6).

¹⁶ 17 CFR 240.19b-4(f)(6)(iii).

¹⁷ For the purposes only of accelerating the operative date of this proposal, the Commission has considered the proposed rule’s impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

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 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 No. SR-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 No. 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 will also 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 No. 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.¹⁸

Margaret H. McFarland
Deputy Secretary

¹⁸ 17 CFR 200.30-3(a)(12).