

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53189; File No. SR-NASD-2006-007)

January 30, 2006

Self-Regulatory Organizations; National Association of Securities Dealers, Inc; Notice of Filing of Proposed Rule Change Relating to Position Limits and Position Reporting Obligations for Conventional Index and Equity Options

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 23, 2006, 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: (a) revise the definition of the term “underlying index” to include 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 the FTSE All-World Index Series.³ The text of the proposed rule change is available on the NASD’s Web site (<http://www.nasd.com>), at the NASD’s principal office, and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Financial Times and the London Stock Exchange operate the FTSE All-World Index Series, which covers approximately 30 different countries and over 1900 stocks.

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

In its filing with the Commission, the 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. The Exchange 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

Amendment to Definition of "Underlying Index"

NASD Rule 2860 governs the activities of members in standardized and conventional options contracts. Paragraph (b)(5) of Rule 2860 imposes a position-reporting obligation on members when they or their customers establish options positions that exceed certain thresholds. Specifically, members are required to file, or cause to be filed, a report with NASD with respect to each account that establishes an aggregate position of 200 or more contracts on the same side of the market covering the same underlying security or index. The current definition of "underlying index" is limited to an index upon which a Nasdaq index option is based.⁴ Since Nasdaq no longer trades any index options, this definition fails to require members to report positions in conventional index options. The proposed rule change would require members to report positions in conventional⁵ index options and would require access firms to report position

⁴ Nasdaq briefly traded stock index options in the mid-1980s.

⁵ A "conventional option" is an option contract not issued or subject to issuance by the Options Clearing Corporation. See Rule 2860(b)(2)(N).

limits in standardized index options.⁶ In a separate filing, in connection with NASD's proposed rule changes to reflect Nasdaq's separation from NASD following the Commission's approval of Nasdaq as a national securities exchange,⁷ NASD has proposed to amend Rule 2860 to remove all references to Nasdaq.⁸

To require members to report members' and customers' positions in conventional index options, NASD proposes amending the definition of "underlying index" to mean an index underlying a "standardized index option" or "conventional index option." In addition, the proposed rule change would define the terms "standardized index option" and "conventional index option." Under the proposed rule change, the definition of "underlying index" would include indexes such as the S&P 500, Dow Jones Industrial Average, and the Nasdaq 100, because these indexes underlie standardized index options that are issued, or subject to issuance, by the Options Clearing Corporation.

The proposed rule change also would amend the definition of "underlying index" to include certain indexes that do not underlie standardized index options but that meet specified criteria. The proposed criteria for customized indexes are based upon the standards in place at the options exchanges for listing narrow-based index options.⁹ The purpose of these criteria is to exclude from the definition of "underlying index" indexes that are so narrowly constructed that

⁶ As noted in Notice to Members 01-01, the options position reporting requirements are applicable to all standardized options positions established by "access" firms or their customers and all conventional options positions established by members or their customers. Access firms, in this context, are understood to be NASD members that conduct a business in standardized options but are not themselves members of the options exchange upon which such options are listed and traded.

⁷ See In the Matter of the Application of the Nasdaq Stock Market LLC, Securities Exchange Act Release No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) (File No. 10-131).

⁸ See Securities Exchange Act Release No. 52049 (July 15, 2005), 70 FR 42398 (July 22, 2005) (SR-NASD-2005-087).

⁹ See, e.g. Chicago Board Options Exchange ("CBOE") Rule 24.2(b).

they are the economic equivalent of, or have attributes of, an equity option on common stock. These criteria also serve to prevent the creation of an index so narrow as to subvert position limit requirements, which do not apply to conventional index options.¹⁰

Under the proposed rule change, a member would have the burden of demonstrating that an index meets the specified criteria before it would be considered a “conventional index option.” Thus, members should maintain detailed records to be able to demonstrate promptly, upon a request from NASD, that a particular “conventional index option” meets the necessary criteria. Members also should be aware that options based on a security that do not meet the definition of “conventional index option” would continue to be subject to position limits and position reporting requirements as if the non-conforming index were deconstructed into its equity security components.

Position Limits for Conventional Equity Options Overlying Certain Foreign Securities

The proposed rule change also addresses the need for members to identify position limits for conventional equity options on securities that do not underlie a standardized equity option. Under Rule 2860(b)(3)(viii), the position limits for conventional equity options are the same as the limits for the standardized equity options overlying the same security. For example, if standardized equity options on ABC have a position limit of 75,000 contracts, then conventional equity options on ABC also have a position limit of 75,000 contracts. On the other hand, for an option on an equally liquid foreign security such as DEF, for which there are no standardized equity options, a member must obtain prior approval from NASD staff for any position limit in

¹⁰ See NASD Notice to Members 94-46 (June 1994).

excess of 13,500 contracts (the base limit in the absence of a pilot program¹¹). Obtaining prior approval could place a significant burden on a member's ability to execute transactions with customers given the time difference between the foreign market and the U.S. market and the time frame in which customers typically desire to trade.

The proposed rule change would allow members to calculate on their own the position limits for conventional equity options overlying securities that are part of the FTSE All-World Index Series using the volume and float criteria (as measured during the most recent six-month period) established by the option exchanges' rules.¹² The position limit levels are described in the chart below:

¹¹ The six national securities exchanges that list and trade options have adopted pilot rules establishing higher position limits for standardized options. These pilots expire between February 23, 2006 and March 3, 2006. See infra note 12.

¹² See Commentary .07 to American Stock Exchange Rule 904, Section 7(c) of Chapter III of the Boston Options Exchange Rules, Interpretation .02 to CBOE Rule 4.11; International Securities Exchange Rule 412(d); Commentary .06 to Pacific Exchange Rule 6.8; Commentary .05 to Philadelphia Stock Exchange Rule 1001.

Options Position Limit	Criteria
22,500 (or 50,000 during the pilot period)	Trading volume of 20,000,000 shares; or Trading volume of 15,000,000 shares, <u>and</u> 40,000,000 shares currently outstanding.
31,500 (or 75,000 during the pilot period)	Trading volume of 40,000,000 shares; or Trading volume of 30,000,000 shares, <u>and</u> 120,000,000 shares currently outstanding.
60,000 (or 200,000 during the pilot period)	Trading volume of 80,000,000 shares; or Trading volume of 60,000,000 shares, <u>and</u> 240,000,000 shares currently outstanding.
75,000 (or 250,000 during the pilot period)	Trading volume of 100,000,000 shares; or Trading volume of 75,000,000 shares, <u>and</u> 300,000,000 shares currently outstanding.

NASD has chosen the FTSE All-World Index Series¹³ in part because the Commission staff has deemed securities in the predecessor to this index of foreign securities to receive comparable treatment to U.S. equity securities under the securities haircut provisions of the Commission's net capital rule as set forth in Rule 15c3-1 under the Exchange Act,¹⁴ and the Federal Reserve

¹³ In the event NASD designates another index in addition to or instead of the FTSE All-World Index Series, NASD will publish the designation of the new applicable index in a Notice to Members and provide members at least 30 days written notice of the change.

¹⁴ Letter to Dominic A. Carone, Capital Committee Chairman, Securities Industry Association from Michael Macchiaroli, Assistant Director, Division of Market Regulation, Commission, dated August 13, 1993. See 1993 SEC No-Act LEXIS 967 (Aug. 13, 1993).

Board recognizes this index for determining whether stocks are eligible for margin treatment.¹⁵ Under the proposed rule change, a member would make a post-trade notice filing—within one business day—to NASD staff providing the necessary trade data and/or current float data to support the member’s position limit calculation. Thus, in the example above, a conventional equity option on DEF would be subject to a position limit of 75,000 contracts rather than 13,500 contracts because the underlying securities’ characteristics meet the volume and float thresholds established by the options exchanges necessary to raise the position limits from 13,500 contracts to 75,000 contracts, provided the member makes the necessary filing within the prescribed time.

Under the proposed rule change, NASD staff would review the member’s notice filing, and, if the staff determined that a member incorrectly assigned a position limit, it would notify the firm and instruct the firm to reduce its position promptly to fall below the appropriate limits determined by the NASD staff.

NASD would 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, if the Commission approves this proposal. The effective date would be 30 days following publication of the Notice to Members announcing any Commission approval.

2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Exchange Act,¹⁶ which requires, among other things, that NASD’s rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and

¹⁵ See Section 220.11(c) and (d) of Regulation T, 12 CFR Part 220.11(c) and (d). See also 69 FR 10601 (March 8, 2004) (removing certain foreign securities from the list of securities that meet the financial requirements of Section 220.11(c) and (d) of Regulation T).

¹⁶ 15 U.S.C. 78q-3(b)(6).

equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that amending the definition of “underlying index” would ensure more complete reporting of options positions. NASD also believes that permitting members to calculate position limits for certain foreign securities would 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 would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act.

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 the 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.

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 Exchange 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 rules-comments@sec.gov. Please include File No. 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 No. 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 will also be available for inspection and copying at the principal office of the 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-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.¹⁷

Nancy M. Morris
Secretary

¹⁷ 17 CFR 200.30-3(a)(12).