

rule change was published for comment in the **Federal Register** on December 30, 2002.⁴ The Commission received no comments on the proposal. This order approves the proposed rule change, and notices and grants accelerated approval to Amendment No. 1 to the proposed rule change.

II. Description of the Proposal

The proposed rule change amends NASD's options position and exercise limits. The proposed rule change establishes six qualified hedge strategies:

1. Where each option contract is "hedged" or "covered" by 100 shares of the underlying⁵ security or securities convertible into the underlying security, or, in the case of an adjusted option, the same number of shares represented by the adjusted contract: (a) Long call and short stock; (b) short call and long stock; (c) long put and long stock; or (d) short put and short stock.

2. *Reverse Conversions*—A long call position accompanied by a short put position, where the long call expires with the short put, and the strike price of the long call and short put is equal, and where each long call and short put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

3. *Conversions*—A short call position accompanied by a long put position where the short call expires with the long put, and the strike price of the short call and long put is equal, and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security.

4. *Collars*—A short call position accompanied by a long put position, where the short call expires with the long put and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of such the underlying security or securities convertible into such underlying

security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

5. *Box Spreads*—A long call position accompanied by a short put position with the same strike price and a short call position accompanied by a long put position with a different strike price.

6. *Back-to-Back Options*—A listed option position hedged on a one-for-one basis with an OTC option position on the same underlying security. The strike price of the listed option position and corresponding OTC option position must be within one strike price interval of each other and no more than one expiration month apart.

Under the proposed rule change, there would be no position and exercise limits when such qualified hedge strategies are effected solely with standardized equity options. In addition, the proposed rule change establishes standardized equity option position and exercise limits of five times the standard limit when one component of such strategies is an OTC option contract. Further, within the list of proposed hedge strategies, NASD proposes that the option component of a reversal, a conversion or a collar position can be treated as one contract rather than as two contracts.

The proposed rule change also modifies the conventional equity options position and exercise limits. First, the proposed rule change expands the hedge exemption for conventional options to include all of the qualified hedge strategies. Second, the proposed rule change increases the conventional equity options position and exercise limits for such qualified hedge strategies to five times the standard limits. Third, the proposed rule change provides that conventional equity options positions under the hedge strategies not be aggregated with other options positions similar to the way that positions under the current equity option hedge exemption and OTC collar aggregation exemption are not aggregated with other options positions.

Under the proposed rule change, the standard position and exercise limits will remain in place for unhedged equity options positions. Once an account reaches the standard limit, positions identified as a qualified hedge strategy would be subject to the increased position limits, or exempted from position limit calculations, as appropriate. The exemption would be automatic (*i.e.*, it will not require pre-approval from NASD) to the extent that a member identifies that a pre-existing qualified strategy is in place or is employed from the point that an account's position reaches the standard

limit and provides the required supporting documentation to NASD.⁶ The exemption would remain in effect to the extent that the exempted position remains intact and NASD is provided with any required supporting documentation.

III. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities associations⁷ and, in particular, the requirements of section 15A of the Act⁸ and the rules and regulations thereunder. The Division finds specifically that the proposed rule change is consistent with section 15A(b)(6) of the Act⁹ because it is designed to promote just and equitable principles of trade, and to protect investors and public interest.

Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. The NASD proposes to expand the hedge exemption from position and exercise limits. The NASD also proposes to modify the conventional equity options position and exercise limits. The Commission believes it is permissible to expand the current equity hedge exemption without risk of disruption to the options or underlying cash markets. The Commission believes that existing position and exercise limits, procedures for maintaining the exemption, and the reporting requirements imposed by the NASD will help protect against potential manipulation. The Commission notes that the existing standard position and exercise limits will remain in place for unhedged equity option positions. To further ensure against market disruption, the NASD will establish a position and exercise limit equal to no greater than five times the standard limit for those hedge strategies that include an OTC option component.

In addition, according to the NASD, once an account reaches the standard

NASD corrected grammatical errors in the rule language text of the proposed rule change.

⁴ See Securities Exchange Act Release No. 47080 (December 23, 2002), 67 FR 79676 (December 30, 2002).

⁵ NASD represents that the phrase "securities convertible into the underlying security" does not include single stock futures products. Telephone Conversation between Gary L. Goldsholle, Associate General Counsel, Office of General Counsel, NASD and Tim Fox, Law Clerk, Division, Commission on December 6, 2002.

⁶ Under the proposed rule change, the existing reporting procedures that serve to identify and document hedged positions above a certain threshold continue to apply. Paragraph (b)(5) of NASD rule 2860 requires reporting to NASD of aggregate positions of 200 more contracts of the put class and the call class on the same side of the market covering the same underlying security.

⁷ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

⁸ 15 U.S.C. 78o-3.

⁹ 15 U.S.C. 78o-3(b)(6).