

Notice of the proposed rule change appeared in the **Federal Register** on January 9, 1995.<sup>7</sup> The Commission did not receive any comments on the proposal. For the reasons discussed below, this order approves the proposed change, as amended.

## II. Description of the Proposed Rule

### A. Background and Purpose

As indicated above, the NASD proposes to allow members to increase the applicable position and exercise limits for conventional options overlying those equity securities that are not subject to standardized options trading if certain conditions are satisfied. For conventional equity options traded by any NASD member, if the underlying security is subject to standardized options trading, the NASD's position limit for conventional options on that security is the same position limit imposed by the options exchange(s) trading the option. Specifically under NASD rules, position and exercise limits for exchange-listed options traded by access firms<sup>8</sup> or their customers are determined according to a "three-tiered" system, where, depending upon the float and trading volume of the underlying security, the position limit for options on that security is 4,500, 7,500, or 10,500 contracts.<sup>9</sup> However, if the security underlying the option is not subject to standardized options trading, the

applicable position limit for conventional options on the security is the lowest tier, *i.e.*, 4,500 contracts.

In some instances, however, a security could be eligible for standardized options trading and qualify for an options exchange position limit of 7,500 or 10,500 contracts but, for purposes of NASD position limits, it is subject to a position and exercise limit of 4,500 contracts because it does not underlie an exchange-listed standardized option. Given that these securities could qualify for higher position limits but are not eligible for them solely because there is no standardized option traded on them in the U.S., the NASD believes its option position limit rule may be unduly restrictive for these securities and unnecessarily constrain members' legitimate hedging activity. Accordingly, the NASD proposes to amend Section 33 to provide that the position limit for options on a security shall be determined by the position limit tier the security falls under, regardless of whether the security is subject to standardized options trading, as long as the security meets the initial and maintenance standards for standardized options trading.

The NASD believes its proposal is warranted for the following reasons. First, if a security has sufficient trading volume and public float to satisfy the standards for a position limit of 7,500 contracts or 10,500 contracts, the NASD does not believe that raising the position and exercise limits for conventional options on the security will adversely affect the cash market for that security. In the NASD's view, if the cash market for a security is large enough to qualify for an options position limit of 7,500 contracts or 10,500 contracts, it is irrelevant whether that security is only subject to conventional options trading and not standardized options trading. The NASD believes the primary consideration governing the appropriate position limit level for options on a security should be the characteristics and size of the underlying cash market for that security, not whether the options overlying the security are standardized or conventional. Second, the NASD does not believe its members' activities in the conventional options market should be linked to or constrained by decisions of the options exchanges concerning whether or not to trade options on particular securities.

Moreover, the NASD believes that its proposal will not compromise the stability of the securities markets underlying the conventional options eligible for the higher position limits. In this regard, for those securities that will be eligible for higher position limits

under the proposal, there will only be a slight increase in the percentage of their capitalization that an investor or group of investors acting in concert can control under the new position limits.

### B. New Proposal

The NASD proposes to permit position and exercise limits of up to either 7,500 or 10,500 contracts, whichever is applicable, for conventional options, if the equity security satisfies the initial criteria and other listing standards for standardized options trading and otherwise qualifies for a higher position and exercise limits of 7,500 or 10,500 contracts.<sup>10</sup> Prior to establishing such a higher position, the member first must demonstrate to the NASD's Market Surveillance Department that the underlying equity security satisfies the initial listing criteria for standardized options trading *and* qualifies for a higher position and exercise limit of 7,500 or 10,500 contracts. The initial listing criteria for standardized options trading are uniform among the five U.S. options exchanges (collectively referred to as the "options exchanges").<sup>11</sup> Likewise, the criteria for qualifying for a higher position and exercise limit of 7,500 or 10,500 contracts is uniform among the options exchanges.<sup>12</sup>

After a member has demonstrated that an equity security meets the criteria for increased position and exercise limits, the increased limit will remain in effect for all other conventional options positions established by the same or other NASD members on that equity

applicable position limit for those options classes. See *NASD Manual*, Rules of Fair Practice, Art. III, Sec. 33(b) (3) & (4), (CCH) ¶ 2183.

<sup>7</sup> Securities Exchange Act Release No. 35180 (Dec. 30, 1994), 60 FR 2413 (Jan. 9, 1995).

<sup>8</sup> "Access" firms are NASD members which conduct a business in exchange-listed options but which are not members of any of the options exchanges upon which the options are listed and traded.

<sup>9</sup> In this connection, the NASD's rules do not specifically govern how a specific equity option falls within one of the three position limit tiers. Rather, the NASD's position limit rule provides that the position limit established by an options exchange(s) for a particular equity option is the applicable position limit for purposes of the NASD's rule. Under the rules of each of the options exchanges, if the security underlying a standardized option has trading volume of 40,000,000 shares over the most recent six-month period or trading volume of 30,000,000 shares over the most recent six-month period and float of 120,000,000, it is subject to a position limit of 10,500 contracts; if the security underlying a standardized option has trading volume of 20,000,000 shares over the most recent six-month period or trading volume of 15,000,000 shares over the most recent six-month period and float of 40,000,000, it is subject to a position limit of 7,500 contracts; and, if the underlying security is ineligible for a 10,500 or 7,500 contract position limit, it is subject to a 4,500-contract position limit. The rules of each options exchange are uniform in regard to the above. See, *e.g.*, Commentary .07 to American Stock Exchange Rule 904 and Interpretation and Policy .02 to Chicago Board Options Exchange Rule 4.11.

<sup>10</sup> For foreign securities, before an option is eligible for standardized options trading, market surveillance sharing arrangements must be satisfied. For the NASD to satisfy these requirements under its proposal, prior to allowing higher (7,500 or 10,500) position and exercise limits for options overlying a foreign security, the NASD will need to ensure that: (1) It has in place a comprehensive surveillance sharing agreement with the primary exchange in the home country where the foreign security is primarily traded; or (2) the combined trading volume of the foreign security (and other related securities) occurring in the U.S. markets represents at least 50% of the combined worldwide trading volume in the underlying security (including other related securities). See Securities Exchange Act Release No. 35554 (Jan. 31, 1994), 59 FR 5622 (Feb. 7, 1994).

<sup>11</sup> The five options exchanges are: Chicago Board Options Exchange ("CBOE"); American Stock Exchange ("Amex"); New York Stock Exchange ("NYSE"); Philadelphia Stock Exchange ("Phlx"); and Pacific Stock Exchange ("PSE"). See *CBOE Rules*, Rule 5.3, (CCH) ¶ 2113; *Amex Rules*, Rule 915, (CCH) ¶ 9715; *NYSE Rules*, Rule 715, (CCH) ¶ 2715; *Phlx Rules*, Rule 1009, (CCH) ¶ 3009; *PSE Rules*, Rule 3.6, (CCH) ¶ 3591.

<sup>12</sup> See *CBOE Rules*, Rules 4.11 & 4.12, (CCH) ¶ 2091 & 2092; *Amex Rules*, Rules 904 & 905, (CCH) ¶ 9704 & 9705; *NYSE Rules*, Rules 704 & 705, (CCH) ¶ 2704 & 2705; *Phlx Rules*, Rules 1001 & 1002, (CCH) ¶ 3001 & 3002; *PSE Rules*, Rules 6.8 & 6.9, (CCH) ¶ 4769 & 4775.