

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Propose Rule Change

The NASD proposes to amend Section 33 of the NASD's Rules of Fair Practice, the NASD's position limit rule for standardized and conventional options, to increase the position and exercise limits for certain equity securities that are not subject to standardized options trading.² In particular, under the proposal, if a security qualifies for a position limit of 7,500 contracts or 10,500 contracts,³ it will be subject to that higher position limit, regardless of whether it has standardized options traded on it or not.

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 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

Currently, under NASD rules, position and exercise limits for exchange-listed options traded by access firms⁴ 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

² Position limits impose a ceiling on the number of option contracts in each class on the same side of the market (*i.e.*, aggregating long calls and short puts and long puts and short calls) that can be held or written by an investor or group of investors acting in concert. Exercise limits restrict the number of options contracts which an investor or group of investors acting in concert can exercise within five consecutive business days. Under NASD Rules, exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise, during any five consecutive business days, only the number of options contracts set fourth as the applicable position limit for those options classes. See Sections 33(b)(3) and (4) of the NASD Rules of Fair Practice.

³ See *infra* note 4 for a description of how the position limit for a particular equity security is determined.

⁴ "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.

for options on that security is 4,500, 7,500, or 10,500 contracts.⁵ For conventional equity options trading by any NASD member,⁶ 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. 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 may qualify for an options position limit of 7,500 or 10,500 contracts but it is subject to a position and exercise limit of 4,500 contracts because it does not underlie a standardized option. Given that these securities 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.⁷

⁵ 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 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.

⁶ Conventional equity options are defined in Section 33(b)(2)(GG) of the NASD Rules of Fair Practice to mean "any option contract not issued, or subject to issuance, by The Options Clearing Corporation."

⁷ To ensure that the higher position limits for conventional options overlying securities not subject to standardized options trading are only available for securities qualifying for a position limit of 7,500 or 10,500 contracts, a member must demonstrate to the NASD's Market Surveillance

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 the 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.

Therefore, the NASD believes the proposed rule change is consistent with Section 15A(b)(6) of the Act. Section 15A(b)(6) requires that the rules of a national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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. Specifically, the NASD believes the proposal will promote the maintenance of fair and orderly markets because it will serve to facilitate the use

Department that the security satisfies the standards for such higher options position limit prior to establishing an unhedged options position on that security in excess of 4,500 contracts.