October 1, 2002

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2002-134**
Proposed Rule Change to Option Position and Exercise Limits; NASD Rule 2860

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-l/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Gary L. Goldsholle, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8104; e-mail gary.goldsholle@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Barbara Z. Sweeney
Senior Vice President
and Corporate Secretary

Enclosures

File No. SR-NASD-2002-134
Consists of 36 Pages

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

National Association of Securities Dealers, Inc.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. <u>Text of Proposed Rule Change</u>

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), the National Association of Securities Dealers, Inc. ("NASD") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to NASD Rule 2860(b)(3)(A) to amend the options position and exercise limits for positions entered into under certain enumerated hedge strategies.[1] Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

* * * * *

2860. Options

(a) No Change

(b) Requirements

(1) and **(2)** No Change

(3) Position Limits

(A) Stock Options--Except in highly unusual circumstances, and with the prior written approval of [the Association] <u>NASD</u> pursuant to the Rule 9600 Series for good cause shown in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, non-member broker, or non-member dealer, an opening transaction through Nasdaq, the over-the-counter market or on any exchange in a stock

[1] The proposed rule language incorporates changes proposed in SR-NASD-2002-104 (filed with the SEC on August 1, 2002), which reflect NASD's corporate restructuring.

option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) 13,500 option contracts of the put class and the call class on the same side of the market covering the same underlying security, combining for purposes of this position limit long positions in put options with short positions in call options, and short positions in put options with long positions in call options; or

(ii) 22,500 option[s] contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 22,500 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 option contracts; or

(iii) 31,500 option contracts of the put class and the call class on the same side of the market covering the same underlying security providing that the 31,500 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 option contracts; or

(iv) 60,000 option[s] contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 60,000 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 option contracts; or

(v) 75,000 option[s] contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 75,000 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 option contracts; or

(vi) such other number of stock option[s] contracts as may be fixed from time to time by [the Association] <u>NASD</u> as the position limit for one or more classes or series of options provided that reasonable notice shall be given of each new position limit fixed by [the Association] <u>NASD</u>.

(vii) Equity Option Hedge Exemption<u>s</u>

<u>a. The following qualified hedge strategies and positions described in subparagraphs 1. through 5. below shall</u>

be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs 6. and 7. below in which one of the option components consists of a conventional option, shall be subject to a position limit of five times the established position limits contained in subparagraphs (i) through (vi) above. Hedge strategies and positions in conventional options as described in subparagraphs 1. through 5. below shall be subject to a position limit of five times the established limits contained in subparagraphs (i) through (vi) above. Options positions limits established under this subparagraph shall be separate from limits established in other provisions of this rule.

1. Where each option contract is "hedged" or "covered" by 100 shares of the underlying 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 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 over-the-counter (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.

7. For reverse conversion, conversion and collar strategies set forth above in subparagraphs 2., 3. and 4., one of the option components can be an OTC option guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account.

[a. The following positions, where each option contract is “hedged” by 100 shares of stock or securities readily convertible into or economically equivalent to such stock, or, in the case of an adjusted option contract, the same number of shares represented by the adjusted contract, shall be exempted from established limits contained in subparagraphs (b)(3)(A)(i) through (vi) above:]

[1. long call and short stock;]

[2. short call and long stock;]

[3. long put and long stock;]

[4. short put and short stock.]

[b. Except as provided in paragraph (b)(3)(A)(ix) and in the OTC Collar Exemption contained in paragraph (b)(3)(A)(viii), in no event may the maximum allowable position, inclusive of options contracts hedged pursuant to the equity option position limit hedge exemption in subparagraph a. above, exceed three times the applicable position limit established in subparagraph (b)(3)(A)(i) through (v) with respect to standardized equity options, or paragraph (b)(3)(A)(ix) with respect to conventional equity options.]

[(viii) OTC Collar Aggregation Exemption]

[a. For purposes of this paragraph (b), the term OTC collar shall mean a conventional equity option position comprised of short (long) calls and long (short) puts overlying the same security that hedge a corresponding long (short) position in that security.]

[b. Notwithstanding the aggregation provisions for short (long) call positions and long (short) put positions contained in subparagraphs (b)(3)(A)(i) through (v) above, the conventional options positions involved in a particular OTC collar transaction need not be aggregated for position limit purposes, provided the following conditions are satisfied:]

[1. the conventional options can only be exercised if they are in-the-money;]

[2. neither conventional option can be sold, assigned, or transferred by the holder without the prior written consent of the writer;]

[3. the conventional options must be European-style (i.e., only exercisable upon expiration) and expire on the same date;]

[4. the strike price of the short call can never be less than the strike price of the long put; and]

[5. neither side of any particular OTC collar transaction can be in-the-money when that particular OTC collar is established.]

[6. the size of the conventional options in excess of the applicable basic position limit for the options established pursuant to subparagraph (b)(3)(A)(ix) above must be hedged on a one-to-one basis with the requisite long or short stock position for the duration of the collar, although the same long or short stock position can be used to hedge both legs of the collar.]

[c. For multiple OTC collars on the same security meeting the conditions set forth in subparagraph b. above, all of the short (long) call options that are part of such collars must be aggregated and all of the long (short) put options that are part of such collars must be aggregated, but the short (long) calls need not be aggregated with the long (short) puts.]

[d. Except as provided above in subparagraphs b. and c., in no event may a member fail to aggregate any conventional options contract of the put class and the call class overlying the same equity security on the same side of the market with conventional option positions established in connection with an OTC collar.]

[e. Nothing in this subparagraph (b)(3)(A)(viii) changes the applicable position limit for a particular equity security.]

[(ix)]<u>(viii)</u> Conventional Equity Options

a. For purposes of [sub]paragraph (b), standardized equity option[s] contracts of the put class and call class on the same side of the market overlying the same security shall not be aggregated with conventional equity option[s] contracts or FLEX Equity Option[s] contracts overlying the same security on the same side of the market. Conventional equity option[s] contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a position limit equal to the greater of:

1. the basic limit of 13,500 contracts, or

2. any standardized equity options position limit as set forth in [sub]paragraphs (b)(3)(A)(ii) through (v) for which the underlying security qualifies or would be able to qualify.

b. In order for a security not subject to standardized equity options trading to qualify for an options position limit of more than 13,500 contracts, a member must first demonstrate to NASD's [the Association's] Market Regulation Department that the underlying security meets the standards for such higher options position limit and the initial listing standards for standardized options trading.

(B) No Change

(4) through **(24)** No Change

* * * * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meeting on July 24, 2002, which authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors had an opportunity to review the proposed rule change at its meeting on July 25, 2002. No other action by NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the NASD By-Laws permits the NASD Board of Governors to amend NASD Rules without recourse to the membership for approval.

NASD will 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. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Gary L. Goldsholle, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8104.

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

(a) Purpose

The proposed rule change amends NASD's options position and exercise limits. Earlier this year, the SEC approved changes to the rules of the Options Exchanges that eliminated standardized equity option[2] position and exercise limits for certain qualified hedge strategies and established position and exercise limits of five times the standard limit for certain of those strategies when they include an over-the-counter (OTC) option contract.[3] NASD is proposing changes to conform its rules to those of the Options Exchanges.

The proposed rule change establishes six qualified hedge strategies:

1. Where each option contract is "hedged" or "covered" by 100 shares of the underlying 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.

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[2] A standardized equity option contract is any equity options contract issued, or subject to issuance by, the Options Clearing Corporation that is not a FLEX Equity Option. NASD Rule 2860(b)(2)(vv).

[3] See 67 Fed. Reg. 14751 (Mar. 27, 2002) (CBOE); 67 Fed. Reg. 15638 (Apr. 2, 2002) (AMEX); 67 Fed. Reg. 18975 (Apr. 17, 2002) (PCX); 67 Fed. Reg. 34980 (May 16, 2002) (PHLX); and 67 Fed. Reg. 48689 (July 25, 2002) (ISE).

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 will 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. All three strategies serve to hedge a related stock portfolio. Because these strategies require the contemporaneous[4] purchase/sale of both a call and put component, against the appropriate number of shares underlying the option (generally 100 shares) NASD believes, like the Options Exchanges, that the position should be treated as one contract for hedging purposes.

[4] At or about the same time.

NASD also establishes position and exercise limits on conventional[5] (or OTC) equity options. The NASD's position limits for conventional equity options are identical to those for standardized options.[6] Moreover, like position and exercise limits for standardized equity options, NASD recognizes certain hedge strategies under which persons can establish greater options positions. NASD currently has an equity option hedge exemption[7] and an OTC collar aggregation exemption.[8] Under the equity option hedge exemption, a person can establish a conventional equity options position of <u>three</u> times the standard position limit. Under the OTC collar aggregation exemption, a person can establish a conventional equity options position of <u>three</u> times the standard position limit for each side of the OTC collar.

The proposed rule change modifies the conventional equity options position and exercise limits in several respects. First, the proposed rule change expands the hedge exemption for conventional options to include all of the qualified hedge strategies. NASD believes that covered stock positions, conversions, reverse conversions, collars[9] and box spreads may all be effected with conventional options. Moreover, having one set of hedge strategies applicable to standardized and conventional options will simplify members' compliance burdens.

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[5] A "conventional option" is any option contract not issued, or subject to issuance, by the Options Clearing Corporation. NASD Rule 2860(b)(2)(N).

[6] NASD Rule 2860(b)(3)(A)(ix).

[7] NASD Rule 2860(b)(3)(A)(vii).

[8] NASD Rule 2860(b)(3)(A)(viii).

[9] NASD Rule 2860(b)(3)(viii) currently contains a collar exemption. For purposes of clarity and consistency, NASD proposes adopting the collar exemption developed by the Options Exchanges in place of its existing collar exemption.

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. This change makes NASD's conventional equity options position limits consistent with the limits for OTC options under the Options Exchange's hedge exemptions. NASD's increased conventional options position limits also will apply when not part of a standardized option hedge. This change avoids having different conventional equity options position and exercise limits apply depending on whether a position is hedged by a standardized or conventional option.

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.

NASD believes that rationales articulated by the SEC in its prior approval of similar rule changes by the Options Exchanges apply equally to the proposed rule change.[10] Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market in the underlying securities. At the same time, the Commission has determined that

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[10] See supra note 3.

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. The proposed rule change is consistent with these Commission policies.

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 will be subject to the increased position limits, or exempted from position limit calculations, as appropriate. The exemption will 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.[11] The exemption will remain in effect to the extent that the exempted position remains intact and NASD is provided with any required supporting documentation.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, 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. Furthermore, the proposed rule change is necessary to keep NASD's rules consistent with similar rules of Options Exchanges approved by the SEC.

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[11] 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 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.

4. <u>Self-Regulatory Organization's Statement on Burden on Competition</u>

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.

5. <u>Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others</u>

Written comments were neither solicited nor received.

6. <u>Extension of Time Period for Commission Action</u>

NASD does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. <u>Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)</u>

Not applicable.

8. <u>Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission</u>

The proposed rule change is being made to ensure that NASD's options position and exercise limits are consistent with those of the Options Exchanges.

9. <u>Exhibits</u>

1. Completed notice of proposed rule change for publication in the <u>Federal Register</u>.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

National Association of Securities Dealers, Inc.

BY:____

Barbara Z. Sweeney , Senior Vice President
and Corporate Secretary

Date: October 1, 2002

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2002-134)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Options Position Limits

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 , the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "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 Rule 2860(b)(3)(A) of the Conduct Rules of the National Association of Securities Dealers, Inc. ("NASD"), to amend the options position and exercise limits for positions entered into under certain enumerated hedge strategies. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * * * *

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b-4.

2860. Options

(a) No Change

(b) Requirements

(1) and **(2)** No Change

(4) Position Limits

(A) Stock Options--Except in highly unusual circumstances, and with the prior written approval of NASD pursuant to the Rule 9600 Series for good cause shown in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, non-member broker, or non-member dealer, an opening transaction through Nasdaq, the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) 13,500 option contracts of the put class and the call class on the same side of the market covering the same underlying security, combining for purposes of this position limit long positions in put options with short positions in call options, and short positions in put options with long positions in call options; or

(ii) 22,500 option[s] contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 22,500 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 option contracts; or

(iii) 31,500 option contracts of the put class and the call class on the same side of the market covering the same underlying security providing that the 31,500 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 option contracts; or

(iv) 60,000 option[s] contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 60,000 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 option contracts; or

(v) 75,000 option[s] contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 75,000 contract position limit shall only be available for option contracts on securities [which] <u>that</u> underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 option contracts; or

(vi) such other number of stock option[s] contracts as may be fixed from time to time by [the Association] NASD as the position limit for one or more classes or series of options provided that reasonable notice shall be given of each new position limit fixed by [the Association] NASD.

(vii) Equity Option Hedge Exemptions

a. The following qualified hedge strategies and positions described in subparagraphs 1. through 5. below shall be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs 6. and 7. below in which one of the option components consists of a conventional option, shall be subject to a position limit of five times the established position limits contained in subparagraphs (i) through (vi) above. Hedge strategies and positions in conventional options as described in subparagraphs 1. through 5. below shall be subject to a position limit of five times the established limits contained in subparagraphs (i) through (vi) above. Options positions limits established under this subparagraph shall be separate from limits established in other provisions of this rule.

1. Where each option contract is “hedged” or “covered” by 100 shares of the underlying 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 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 over-the-counter (OTC) option position on the same underlying security. The strike price of the listed option position and corresponding OTC option position must

<u>be within one strike price interval of each other and no more than one expiration month apart.</u>

<u>7. For reverse conversion, conversion and collar strategies set forth above in subparagraphs 2., 3. and 4., one of the option components can be an OTC option guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account.</u>

[a. The following positions, where each option contract is "hedged" by 100 shares of stock or securities readily convertible into or economically equivalent to such stock, or, in the case of an adjusted option contract, the same number of shares represented by the adjusted contract, shall be exempted from established limits contained in subparagraphs (b)(3)(A)(i) through (vi) above:]

[1. long call and short stock;]

[2. short call and long stock;]

[3. long put and long stock;]

[4. short put and short stock.]

[b. Except as provided in paragraph (b)(3)(A)(ix) and in the OTC Collar Exemption contained in paragraph (b)(3)(A)(viii), in no event may the maximum allowable position, inclusive of options contracts hedged pursuant to the equity option position limit hedge exemption in subparagraph a. above, exceed three times the applicable position limit established in subparagraph (b)(3)(A)(i) through (v) with respect to standardized equity options, or paragraph (b)(3)(A)(ix) with respect to conventional equity options.]

[(viii) OTC Collar Aggregation Exemption]

[a. For purposes of this paragraph (b), the term OTC collar shall mean a conventional equity option position comprised of short (long) calls and long (short) puts overlying the same security that hedge a corresponding long (short) position in that security.]

[b. Notwithstanding the aggregation provisions for short (long) call positions and long (short) put positions contained in subparagraphs (b)(3)(A)(i) through (v) above, the conventional options positions involved in a particular OTC collar transaction need not be aggregated for position limit purposes, provided the following conditions are satisfied:]

[1. the conventional options can only be exercised if they are in-the-money;]

[2. neither conventional option can be sold, assigned, or transferred by the holder without the prior written consent of the writer;]

[3. the conventional options must be European-style (i.e., only exercisable upon expiration) and expire on the same date;]

[4. the strike price of the short call can never be less than the strike price of the long put; and]

[5. neither side of any particular OTC collar transaction can be in-the-money when that particular OTC collar is established.]

[6. the size of the conventional options in excess of the applicable basic position limit for the options established pursuant to subparagraph (b)(3)(A)(ix) above must be hedged on a one-to-one basis with the requisite long or short stock position for the duration of the collar, although the same long or short stock position can be used to hedge both legs of the collar.]

[c. For multiple OTC collars on the same security meeting the conditions set forth in subparagraph b. above, all of the short (long) call options that are part of such collars must be aggregated and all of the long (short) put options that are part of such collars must be aggregated, but the short (long) calls need not be aggregated with the long (short) puts.]

[d. Except as provided above in subparagraphs b. and c., in no event may a member fail to aggregate any conventional options contract of the put class and the call class overlying the same equity security on the same side of the market with conventional option positions established in connection with an OTC collar.]

[e. Nothing in this subparagraph (b)(3)(A)(viii) changes the applicable position limit for a particular equity security.]

[(ix)]<u>(viii)</u> Conventional Equity Options

a. For purposes of [sub]paragraph (b), standardized equity option[s] contracts of the put class and call class on the same side of the market overlying the same security shall not be aggregated with conventional equity option[s] contracts or FLEX Equity Option[s] contracts overlying the same security on the same side of the market. Conventional equity option[s] contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a position limit equal to the greater of:

1. the basic limit of 13,500 contracts, or

2. any standardized equity options position limit as set forth in [sub]paragraphs (b)(3)(A)(ii) through (v)

for which the underlying security qualifies or would be able to qualify.

b. In order for a security not subject to standardized equity options trading to qualify for an options position limit of more than 13,500 contracts, a member must first demonstrate to NASD's [the Association's] Market Regulation Department that the underlying security meets the standards for such higher options position limit and the initial listing standards for standardized options trading.

(B) No Change

(4) through **(24)** No Change

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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

(a) Purpose

The proposed rule change amends NASD's options position and exercise limits. Earlier this year, the SEC approved changes to the rules of the Options Exchanges that eliminated standardized equity option[3] position and exercise limits for certain qualified hedge strategies and established position and exercise limits of five times the standard limit for certain of those strategies when they include an over-the-counter (OTC) option contract.[4] NASD is proposing changes to conform its rules to those of the Options Exchanges.

The proposed rule change establishes six qualified hedge strategies:

1. Where each option contract is "hedged" or "covered" by 100 shares of the underlying 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.

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[3] A standardized equity option contract is any equity options contract issued, or subject to issuance by, the Options Clearing Corporation that is not a FLEX Equity Option. NASD Rule 2860(b)(2)(vv).

[4] See 67 Fed. Reg. 14751 (Mar. 27, 2002) (CBOE); 67 Fed. Reg. 15638 (Apr. 2, 2002) (AMEX); 67 Fed. Reg. 18975 (Apr. 17, 2002) (PCX); 67 Fed. Reg. 34980 (May 16, 2002) (PHLX); and 67 Fed. Reg. 48689 (July 25, 2002) (ISE).

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 will 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. All three strategies serve to hedge a related stock portfolio. Because these strategies require the contemporaneous[5] purchase/sale of both a call and put component, against the appropriate number of shares underlying the option (generally 100 shares) NASD believes, like the Options Exchanges, that the position should be treated as one contract for hedging purposes.

NASD also establishes position and exercise limits on conventional[6] (or OTC) equity options. The NASD's position limits for conventional equity options are identical to those for standardized options.[7] Moreover, like position and exercise limits for standardized equity

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[5] At or about the same time.

[6] A "conventional option" is any option contract not issued, or subject to issuance, by the Options Clearing Corporation. NASD Rule 2860(b)(2)(N).

[7] NASD Rule 2860(b)(3)(A)(ix).

options, NASD recognizes certain hedge strategies under which persons can establish greater options positions. NASD currently has an equity option hedge exemption[8] and an OTC collar aggregation exemption.[9] Under the equity option hedge exemption, a person can establish a conventional equity options position of three times the standard position limit. Under the OTC collar aggregation exemption, a person can establish a conventional equity options position of three times the standard position limit for each side of the OTC collar.

The proposed rule change modifies the conventional equity options position and exercise limits in several respects. First, the proposed rule change expands the hedge exemption for conventional options to include all of the qualified hedge strategies. NASD believes that covered stock positions, conversions, reverse conversions, collars[10] and box spreads may all be effected with conventional options. Moreover, having one set of hedge strategies applicable to standardized and conventional options will simplify members' compliance burdens.

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. This change makes NASD's conventional equity options position limits consistent with the limits for OTC options under the Options Exchange's hedge exemptions. NASD's increased conventional options position limits also will apply when not part of a standardized option hedge. This change avoids having different conventional equity options position and exercise

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8 NASD Rule 2860(b)(3)(A)(vii).

9 NASD Rule 2860(b)(3)(A)(viii).

10 NASD Rule 2860(b)(3)(viii) currently contains a collar exemption. For purposes of clarity and consistency, NASD proposes adopting the collar exemption developed by the Options Exchanges in place of its existing collar exemption.

limits apply depending on whether a position is hedged by a standardized or conventional option.

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.

NASD believes that rationales articulated by the SEC in its prior approval of similar rule changes by the Options Exchanges apply equally to the proposed rule change.[11] Position and exercise limits serve as a regulatory tool designed to address potential manipulative schemes and adverse market impact surrounding the use of options. In general, the Commission has taken a gradual, evolutionary approach toward expansion of position and exercise limits. The Commission has been careful to balance two competing concerns when considering the appropriate level at which to set position and exercise limits. The Commission has recognized that the limits must be sufficient to prevent investors from disrupting the market in the underlying securities. 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. The proposed rule change is consistent with these Commission policies.

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 will be subject to the increased position limits, or

[11] See supra note 3.

exempted from position limit calculations, as appropriate. The exemption will 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.[12] The exemption will remain in effect to the extent that the exempted position remains intact and NASD is provided with any required supporting documentation.

(b) Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, 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. Furthermore, the proposed rule change is necessary to keep NASD's rules consistent with similar rules of Options Exchanges approved by the SEC.

(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.

[12] 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 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.

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 self-regulatory organization 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. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. 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 submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary