



**Securities Industry Association**

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May 23, 2006

Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-7553

Re: Notice of National Association of Securities Dealers, Inc. Filing of Proposed Rule Change  
Relating to Position Limits and Position Reporting Obligations for Conventional Index and  
Equity Options  
[Release No. 34-53189; File No. SR-NASD-2006-007]

Dear Ms. Morris:

The Derivative Products Committee (the “Committee”) of the Securities Industry Association (the “SIA”)<sup>1</sup> is submitting this letter in response to the Securities and Exchange Commission (the “Commission” or “SEC”) request for comment on the captioned Proposed Rule Change (“Proposed Rule Change”) filed by the National Association of Securities Dealers, Inc. (“NASD”).<sup>2</sup>

The Committee welcomes the opportunity to submit comments on the Proposed Rule Change. The Committee endorses the adoption of clear and objective criteria for identifying those index options that would be exempt from NASD option position and exercise limits. The Committee’s comments are intended to further that objective while streamlining the relevant standards and easing the operational steps necessary for NASD member firms to verify compliance with the Proposed Rule Change. The Committee’s comments are summarized immediately below.

**I. Definition of Covered Indices.**

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<sup>1</sup> The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated \$322.4 billion in domestic revenue and an estimated \$474 billion in global revenues. (More information about SIA is available at: [www.sia.com](http://www.sia.com).)

<sup>2</sup> 71 Fed. Reg. 6117 (Feb. 6, 2006).

The NASD's proposed definition of index options is drawn from existing exchange rule definitions applicable to standardized options. We agree that it is generally

appropriate (subject to the discussions below and in Section II) to achieve consistency across conventional and standardized options for these purposes. We further believe that the objective of any definition of an "index option" for these purposes should be to exclude any index that may operate as a surrogate for trading in one of the component equity securities comprising the index.

In light of the foregoing, the Committee recommends that the definition of an index option, for purposes of NASD option position and exercise limits applicable to conventional options, be defined so as to include:

1. Any conventional option overlying an index that underlies a standardized index option as defined in the rules of a national securities exchange (subject to the discussion below and in Section II); and
2. Any conventional option overlying a basket or index of securities that satisfies the following criteria:
  - A. The basket or index comprises 9 or more equity securities;
  - B. No equity security comprises more than 30% of the equity security component of the basket's or index's weighting; and
  - C. Each equity security comprising the basket or index, as of the trade date of the option:
    - (a) is a component security in either the Russell 3000 Index or the FTSE All-World Index Series; or
    - (b) has:
      - (i) market capitalization of at least \$75 million or, in the case of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, \$50 million; and
      - (ii) trading volume for each of the preceding six months of at least one million shares or, in the case of each of the lowest weighted component securities in the basket or index that in the aggregate account for no more than 10% of the weight of the index, 500,000 shares.

The foregoing criteria would provide results consistent with the NASD's objectives and, at the same time, incorporate standards that, in most cases, will be more readily verifiable by member firms and therefore present reduced operational risks and burdens.

Specifically, Clause 1 above would, in effect, incorporate by reference the index definitions contained in exchange rules that are separately approved by the Commission from time to time. By incorporating the index option definition under exchange rules by reference, the

proposed standard would obviate the need for the NASD to constantly monitor changes in applicable exchange rules and to implement conforming rule changes. As a result, we believe this largely formalistic modification would lead to more efficient utilization of NASD and Commission resources in the future and establish a ready reference of qualifying indices for member firms.

The criteria set forth in Clause 2 above are based on a combination of the Commission's own definition of an index that is not a "narrow-based security index" under the Securities Exchange of 1934 ("~~34 Act~~") Rule 3(a)(55)(C) and the quantitative standards for capitalization and average daily trading volume contained in the NASD's Proposed Rule Change. In lieu of actually measuring these statistics in all cases, the Committee proposes to incorporate securities that are included in the Russell 3000 Index or the FTSE World Index Series, as the standards for inclusion in these indices make these a reasonable surrogate for the specific quantitative capitalization and liquidity standards summarized above. Securities that are not included in either index would be subject to the objective capitalization and liquidity criteria set forth in Clauses 2.C(b)(i) and (ii).

As the Commission will note, the Committee has not proposed any criteria that would limit the underlying securities to those that are registered under Section 12 of the '34 Act or that are Regulation NMS securities. We have omitted any such limitation in light of the fact that those limitations, although relevant to other securities law policy objectives sought to be furthered by the Commission's narrow-based security index definition and exchange listing standards for index options, are not relevant in determining whether an index is effectively a surrogate for an individual component security. We note in this regard that members transacting in conventional index options must separately ensure that their trading activities in connection with such options comport with applicable Securities Act of 1933 requirements. Accordingly, the Committee does not believe that any such limitation is necessary or appropriate in the context of conventional index options.

## II. A.M.-Settlement Requirement.

The Proposed Rule Change incorporates the standardized index option requirement that underlying indices be designated as "A.M.-settled". The Committee notes that, as a matter of practice in the over-the-counter options market, conventional index options are not A.M.-settled. The Committee recognizes that the Commission and exchanges have imposed this requirement on standardized index options in order to facilitate market balancing operations that are intended to minimize the risk of market congestion and disorderly trading in connection with the exercise and settlement of such options and related transactions. The Committee fully supports this objective. Nonetheless, the Committee notes that conventional index options of the type that would be covered by the Proposed Rule Change have been trading without position or exercise limits, and without any A.M.-settlement requirement, for many years without giving rise to disruption, disorderly trading or other settlement problems affecting the standardized index option markets, index futures (or futures option) markets or underlying cash equity markets.

We believe that that empirical record clearly supports the conclusion that the imposition of an A.M.-settlement requirement in the context of conventional index options is not necessary or warranted. If the Commission or the NASD nonetheless have concerns regarding potential settlement disruptions, the Committee recommends that NASD impose A.M.-settlement

requirements only where: (1) the conventional index option overlies an index that underlies a standardized index option; and (2) the conventional index option settles on the same day as the day that is the settlement date of such standardized index option and the futures contracts and futures option contracts on the same underlying index.

### III. Hybrid Indices Comprising Assets in addition to Equity Securities.

As the Commission is aware, NASD position and exercise limits apply only to equity options. Increasingly, however, customized conventional index options may overlie assets, or relationships between asset categories, additional to equity securities. Recognizing this, the Committee recommends that the definition of index be permitted to incorporate any debt security, or any non-security asset, index or interest of any kind, provided that the equity security component of the index satisfies the criteria enumerated in Section I above.

### IV. Option Position Reporting Levels

The Committee additionally believes that option position reporting levels should be updated. Specifically, the Committee recommends that conventional index options, other than conventional index options overlying an index that underlies a standardized index option, should be exempt from position reporting requirements. For conventional options overlying indices that underlie standardized options, option position reporting levels should be raised significantly above the current 200 contract reporting threshold. The Committee recommends a position reporting threshold of 10,000 contracts for this category of index options.<sup>3</sup>

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<sup>3</sup> The Committee further recommends that, consistent with the harmonization of reporting thresholds for conventional and standardized options generally, exchange reporting levels be raised for this category of index options to any increased reporting level adopted by the NASD pursuant to the Proposed Rule Change.

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We thank the Commission for the opportunity to share the Committee's comments on the Proposed Rule Change. If the Commission has any questions or would like further information regarding the foregoing comments, please feel free to contact Gerard J. Quinn, Staff Adviser to the Committee, at 212-618-0507 or Edward J. Rosen of Cleary, Gottlieb, Steen & Hamilton, counsel to the Committee, at 212-225-2820.

Very truly yours,

*/s/ John R. Vitha*

John R. Vitha, Esq.

Chairman

SIA Derivative Products Committee

c: Elizabeth K. King  
Gary Goldsholle