

OPTIONS EXCHANGE			
Regulatory Information Circular			
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## Subject: Delta Position Limit Exemption

Effective immediately, the SEC has approved a change to ISE Rule 413 that allows approved entities to apply a delta hedge exemption for position limit purposes.

The ISE is issuing this Circular to provide guidance to members that wish to use the delta hedge exemption.

### Frequently Asked Questions

#### **1. What is a delta hedge exemption?**

The delta hedge exemption allows an eligible member or non-member affiliate of a member to apply a delta to an equity options position<sup>1</sup> to calculate its overall net position for position limit purposes, which includes the netting of the long call/short put positions with the long put/short call positions in a particular security.

This is an additional hedge exemption to the existing seven exemptions listed in ISE Rule 413.

#### **2. Who is eligible to use the delta hedge exemption?**

Members or non-member broker-dealers and certain other financial institutions that use a "permitted pricing model" as defined in ISE Rule 413 are eligible to use the exemption.

In support of the delta position limit effort, The Options Clearing Corporation ("OCC") will provide subscribers with an OCC generated delta value for each option.

Customer accounts are not eligible to apply the delta hedge exemption.

#### **3. When will the delta hedge exemption become effective?**

The delta hedge exemption became effective on February 1, 2008.

<sup>1</sup> Equity option positions include options on Exchange Traded Funds ("ETFs"). Please note that index options are currently not approved for a delta hedge exemption.

#### **4. What do I need to do to apply the delta hedge exemption?**

An entity that is eligible to rely on the delta hedge exemption must **first** provide the ISE with a written certification that the entity uses a “permitted pricing model” and is therefore eligible to apply this exemption.

A member carrying an account of a non-member affiliate that intends to rely on this exemption must first obtain from such non-member:

1. A written certification to the ISE that it is using a “permitted pricing model” and is therefore eligible to apply this exemption; and,
2. A written statement confirming that the non-member affiliate:
  - is relying on this exemption;
  - will use only a permitted pricing model for purposes of net delta calculations;
  - will promptly notify the member if it ceases to rely on this exemption;
  - authorizes the member to provide information to the ISE or OCC;
  - if using the OCC pricing model, has duly executed and delivered to the ISE such documents as the ISE may require as a condition for reliance on the exemption.

At this time the ISE expects that members and non-member affiliates electing to use the delta hedge exemption will inform the ISE of the specific account or entity identifying information that it intends to use to satisfy the reporting obligations of the exemption.

It is expected that the options exchanges and the Financial Industry Regulatory Authority (“FINRA”) will include position limits, including the use of the delta hedge exemption, in a coordinated regulatory program pursuant to a “17d-2 agreement” in the near future<sup>2</sup>.

When the 17d-2 agreement is expanded to include position limits, common members of the 17d-2 participants will be allocated to one of the regulatory participants.

#### **5. Does the delta hedge exemption apply to the firm’s overall position or can the firm use this exemption for specific accounts?**

A firm can apply the delta hedge exemption either to its entire position in a particular security or to the positions in a particular security held by one or more of its’ **approved** “aggregation units.” Within each aggregation unit there can be several trading units, as described in ISE Rule 413 (See bullet 9 for additional information on trading units).

In order for an “aggregation unit” to be approved, the firm must submit a written request to the ISE Market Surveillance Department or to the member’s assigned regulator, as applicable (see 4 above), describing the aggregation unit, including specifically the reporting structure within the aggregation unit and the control aspects of the management for the unit, citing any overlaps in responsibilities. This should be followed with an explanation as to why the unit should be separated from the rest of the firm for position limit purposes.

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<sup>2</sup> The American Stock Exchange LLC (Amex); Boston Stock Exchange, Inc. (BOX); the Chicago Board Options Exchange, Inc. (CBOE), the International Securities Exchange LLC (ISE); NYSE Arca, Inc. (NYSE); the Philadelphia Stock Exchange, Inc. (PHLX) and FINRA, participate in an arrangement for allocation of regulatory responsibility pursuant to SEC Rule 17d-2.

**6. What is an “Option Contract Equivalent of the Net Delta (OCEND)?”**

The OCEND is an aggregate position number adjusted for a series delta and is subject to the appropriate position limit.

For example, if a firm has a long call/short put position of 300,000 contracts with a 0.5 delta and a long put/short call position of 200,000 contracts with a 0.25 delta, the OCEND would be **long 100,000** deltas  $(300,000 * 0.5) - (200,000 * 0.25)$  for position limit reporting purposes.

Note that without applying the delta hedge exemption, this firm would be long 300,000 contracts and short 200,000 contracts for position limit reporting purposes as these positions could not be aggregated.

The OCEND should be submitted using the same specific account or entity identifying information that the firm provided to the ISE upon notice of intent to elect the delta hedge exemption.

**7. What are the reporting requirements if the delta hedge exemption is applied to the firm’s entire position in a particular security (no separate aggregation units)?**

A) For OCC members, the requirement is:

Report the OCEND to the OCC through the “Delta Based Position Limit Aggregator Report” when the firm’s equity options position in a particular security exceeds the position limit on a contract basis.

B) For non-OCC members, the requirements are:

- i) Report the OCEND to the OCC through the “Delta Based Position Limit Aggregator Report” when the firm’s equity options position in a particular security exceeds the position limit on a contract basis.
- ii) Report to the Large Option Position Report (“LOPR”) when a position is greater than or equal to 200 contracts on the same side of the market (no change to the current reporting requirements). The LOPR should also be submitted using the same specific account or entity identifying information that it provided to the ISE upon notice of intent to elect the delta exemption.

**8. What are the reporting requirements if a firm wants to apply the delta hedge exemption to different aggregation units?**

For OCC and non-OCC members, the requirements are:

- A) Report the OCEND to the OCC through the “Delta Based Position Limit Aggregator Report” when the aggregation unit’s equity options position in a particular security exceeds the position limit on a contract basis.
- B) Report to the LOPR when a position is greater than or equal to 200 contracts on the same side of the market for each aggregation unit.
- C) The account or entity identifying information on these reports should be consistent with the specific account or entity identifying information provided to the ISE upon notice of intent to elect the delta hedge exemption.

**9. What should I report if an aggregation unit has one or more trading units that do not use the delta hedge exemption?**

The entity must combine the OCEND of the trading units using the delta hedge exemption with the positions on a contract basis of the trading units not using the exemption.

For example, if Aggregation Unit A has an OCEND of long 200,000 deltas, and a trading unit within Aggregation Unit A that is not using delta is long 60,000 contracts and short 20,000 contracts, the firm should report 260,000 deltas to the "Delta Based Position Limit Aggregator Report." Since the trading unit is not using delta, the firm may not net the 260,000 contract equivalent long position with the 20,000 contract short position to lessen the net deltas reported.

**10. Is there a technical document that describes how to submit the OCEND to the "Delta Based Position Limit Aggregator Report?"**

The OCC has published a user guide that provides technical specifications on how to submit position information to the "Delta Based Position Limit Aggregator Report." The *ENCORE Delta Position Limits Reference Guide for Clearing Members* is available through this link:

[http://www.optionsclearing.com/products/delta\\_position\\_limits.jsp](http://www.optionsclearing.com/products/delta_position_limits.jsp)

Failure to report the OCEND may result in regulatory action.

**11. Does the Delta Hedge Exemption apply both to standardized and conventional options?**

Yes, the delta hedge exemption applies to standardized and conventional options separately.

For example, IBM options would have a 250,000 contract position limit in the standardized options and, under NASD rules, a separate 250,000 contract position limit in the conventional options.

**12. Does the Delta Hedge Exemption apply to correlated securities other than the underlying?**

No. At this time the delta hedge exemption only is available for securities that directly underlie the applicable option position. For example, this means that for a position in IWM options (options on the iShares<sup>®</sup> Russell 2000<sup>®</sup> Index Fund), the exemption is available where the position is hedged with the underlying ETF, but not where the position is hedged with the related Russell 2000<sup>®</sup> Index (RUT) options.

Please contact Willie Wong at (212) 897-8126, Ron Veith at (212) 897-8130, Khalid Essafi at 212-897-8133, or myself with any questions.