exercise instructions are submitted to the clearing members, without having the audit trail pass directly through the NASD or the particular options exchange(s) trading the expiring option, it is difficult for the NASD to surveil for violations of Section 63. In fact, there have been some situations where members have either delayed making exercise decisions until after the Exercise Cut-Off Time in anticipation of the release of significant news concerning a particular underlying company or, having made exercise decisions prior to the Exercise Cut-Off Time, changed these decisions based upon such news. In one notable situation, certain firms that anticipated the release of material news regarding a particular company allegedly delayed making their exercise decisions until after the Exercise Cut-Off Time, causing firms who claimed to have been disadvantaged by such conduct to commence a series of highly publicized arbitration proceedings and lawsuits.7

Accordingly, in order to enable the options exchanges and the NASD to determine whether options holders have made their final exercise decisions no later than the prescribed Exercise Cut-Off Time and not on the basis of market developments occurring after the Exercise Cut-Off Time, the NASD proposes to amend Section 63 of the Practice Code to provide for an exercise advice procedure. Specifically, the proposed rule change will alter the existing exercise instruction procedures by requiring the final exercise decisions also be submitted to the relevant options exchange(s) trading a particular equity option. The clearing members will still be responsible for delivering exercise notices to OCC, however, the proposed rule change will allow the NASD, in conjunction with the options exchanges, to accurately document when each exercise instruction was received by a member or clearing member or delivered by a clearing member to OCC.8 The Exercise Cut-Off Time will still be 5:30 p.m. (E.S.T.) on the business day immediately prior to the expiration date.

In particular, under the proposal, there will be two means of exercising an expiring equity option: (1) Take no action and allow exercise determinations to be made in

accordance with OCC Rule 805; 9 or (2) members may submit a contrary exercise advice (i.e., a notice committing an option holder either to exercise an option that would not otherwise be exercised automatically pursuant to OCC Rule 805, or not to exercise an option that otherwise would be exercised automatically pursuant to OCC Rule 805) ("Contrary Exercise Advice"). A Contrary Exercise Advice will be submitted by NASD members: (1) to a place designated for that purpose by any national options exchange of which they are a member and where the particular equity option is listed; (2) to a place designated for that purpose by any national options exchange that lists and trades that equity option via a member of such exchange if the member is not a member of such exchange; (3) to any national options exchange of which they are a member and where the equity option is listed via OCC in a form prescribed by OCC; 10 or (4) to any national options exchange where the equity option is listed via OCC in a form prescribed by OCC, provided the member is a member of OCC. In those instances where OCC Rule 805 has been waived by OCC,11 the proposal provides that a Contrary Exercise Advice must be submitted prior to the Exercise Cut-Off Time by members wanting to exercise an option that would not have been automatically exercised, or not to exercise an option that would have been automatically exercised, had OCC's exercise-byexception procedure been in effect.12 The applicable underlying security price in such instances will be as described in OCC Rule 805(1), which is normally the last sale price in the

primary market for the underlying security.

The proposal also requires that members maintaining proprietary or public customer positions in expiring options take necessary steps to ensure that final exercise decisions are properly indicated to the relevant national options exchange with respect to such positions. In addition, the proposal provides that members who have accepted the responsibility of indicating final exercise decisions on behalf of another member also shall take necessary steps to ensure that such decisions are properly indicated to the relevant national options exchange. In this regard, the proposal also provides that members may establish an internal processing cut-off time prior to 5:30 p.m. (E.S.T.), at which time the member will no longer accept final exercise decisions from its customers in expiring options.

With certain minor modifications, ¹³ the proposal maintains the current exceptions to Section 63 of the Practice Code. The proposal, however, does add language to Section 63(b)(3) to expressly state that the burden of establishing an exception to the Exercise Cut-Off Time for a proprietary or customer account of a member rests solely on the member seeking to rely on such exception.

In the event a member does not timely submit a Contrary Exercise Advice pursuant to an exception, the responsible member must prepare a written memorandum describing the circumstances surrounding the late submission of the Contrary Exercise Advice and stating the time when such final exercise decision was made or, in the case of customer, was received. The member must also file a copy of the memorandum with the market surveillance department of the national options exchange trading the option, if it is a member of such exchange, or the NASD's Market Surveillance Department, if it is not a member of such exchange, no later than 12:00 p.m. (E.S.T.) on the business day following that expiration.

Furthermore, in order to highlight the seriousness of violating Section 63 of the Practice Code, the proposed rule language expressly states that submitting or preparing an exercise instruction after the Exercise Cut-Off Time in any expiring equity option on the basis of material information

⁷ See, e.g., In re Farmers Group Stock Options Litigation, Master File No. 88–4994 (E.D.Pa).

⁸ Because OCC's rules are not affected by this rule proposal, the reporting of final exercise decisions as contemplated by the revised rule does not serve to substitute as the effective exercise notice to OCC for the exercise or nonexercise of expiring options.

⁹ OCC Rule 805 provides for the automatic exercise of in-the-money options at expiration without the submission of an exercise notice to OCC if the price of the security underlying the option is at or above a certain price for calls or at or below a certain price for puts; and the non-exercise of an option at expiration if the price of the security underlying the option does not satisfy such price levels. See OCC Rule 805.

¹⁰ Even through this may be accomplished by submitting exercise decisions directly to the relevant options exchange, the more likely manner of accomplishing this will be to submit the exercise decisions to the options exchanges through C/MACS. The OCC has represented that all necessary systems modifications have been made and fully tested in order for the proposed exercise procedures described herein to be implemented for the next Expiration Friday on February 17, 1995. See Letter from James Young, First Vice President and General Counsel, OCC, to Brad Ritter, Senior Counsel, Office of Market Supervision, Division of Market Regulation, Commission, dated February 13, 1995.

¹¹This could happen when an underlying security is not traded on its primary market on the trading day immediately preceding an expiration date and, as a result, OCC determines not to fix a closing price for that security. See OCC Rule 805(l).

¹² See supra note 9.

¹³ Specifically, in order to conform the NASD's proposed rule with the rules of the options exchanges, the NASD proposes to delete the exemption that applies to "option contracts carried in an account maintained for another member in which only positions of customers of such other member are carried."