Practice Code to provide for an exercise advice procedure. Specifically, the proposed rule change will alter the existing exercise instruction procedures by requiring that 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.5 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; 6 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 either: (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; ⁷ 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,8 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.9 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 to indicate 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 connection, 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, ¹⁰ 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 a 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 released after the Exercise Cut-Off Time is activity inconsistent with just and equitable principles of trade. The proposal also states that the requirements specified in Section 63(b) will not apply to standardized foreign currency options or standardized index option products.

The NASD represents that the proposed rule change reflects a coordinated effort among all the options exchanges, the NASD, and OCC. In particular, the NASD represents that the proposed exercise advice procedure has been reviewed and endorsed by the Intermarket Surveillance Group ("ISG"),¹¹ which is in the process of issuing a joint circular explaining the operation of the new exercise cut-off provisions. The NASD notes that the Commission has already approved similar rule proposals from each of the national options exchanges.¹²

Continued

⁵Because 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 non-exercise of expiring options.

⁶ OCC Rule 805 provides for the automatic exercise of in-the-money options of 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.

⁷Even though 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. Due to the burden that would be placed on

members by having to manually process every exercise decision for delivery directly to the relevant options exchange, the procedures and rules being proposed herein will not be implemented by the NASD until OCC submits a written representation to the Commission that C/MACS has been modified as necessary, fully tested, and ready to go on-line to allow members to submit exercise decisions to the options exchanges through C/MACS. The Commission notes that the procedures and rules proposed herein are scheduled for implementation in time for the February 1995 equity option expirations.

⁸This 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(1).

⁹ See supra note 6.

¹⁰ 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."

¹¹ ISG was formed on July 14, 1983 to, among other things, coordinate more effectively surveillance information sharing arrangements in the stock and options markets. See Intermarket Surveillance Sharing Group Agreement, July 14, 1983. The members of ISG are the American Stock Exchange, Inc., the Boston Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the Chicago Stock Exchange, Inc., the Cincinnati Stock Exchange, Inc., the NASD, the New York Stock Exchange, Inc., the Pacific Stock Exchange, Inc., and the Philadelphia Stock Exchange, Inc.,

¹² See Securities Exchange Act Release Nos. 34806 (October 7, 1994), 59 FR 52339 (October 17,