require frequent, costly and time-consuming correspondence between self-regulatory organizations and their member firms for the purpose of identifying the accounts involved in trading activity.

The NYSE and the Securities Industry Automation Corporation ("SIAC"), however, have initiated studies to determine the cost and feasibility of distinguishing between firm proprietary and customer trading, and of obtaining customer account identification information in the stock clearing process. They have represented that these studies will be completed by March 31, 1979. 14/

Accordingly, the Options Study recommends:

> THE COMMISSION SHOULD REVIEW THE SIAC REPORT CONCERNING FIRM PROPRIETARY AND CUSTOMER TRADING AS SOON AS IT IS COMPLETED. THE SELF-REGULATORY ORGANIZATIONS AND THEIR MEMBER FIRMS SHOULD WORK TO ESTABLISH AN ECONOMICAL METHOD FOR IDENTIFYING AND DISTINGUISHING MEMBER FIRM PROPRIETARY AND CUSTOMER STOCK ORDERS AND TRANSACTIONS. IN THE EVENT THAT THE SELF-REGULATORY ORGANIZATIONS DO NOT DEVISE A METHOD FOR EASILY IDENTIFYING MEMBER FIRM PROPRIETARY AND CUSTOMER TRADING, THE COMMISSION SHOULD CONSIDER WHETHER IT IS APPROPRIATE TO REQUIRE THAT THEY DO SO BY COMMISSION RULE.
>
> IN ADDITION, THE COMMISSION SHOULD BEGIN TO STUDY THE MOST APPROPRIATE MEANS OF ESTABLISHING A UNIFORM METHOD OF IDENTIFYING STOCK AND OPTION CUSTOMERS ON A ROUTINE, AUTOMATED BASIS. THE COMMISSION SHOULD REVIEW THE NYSE AND SIAC REPORT ON THIS SUBJECT AND SHOULD DETERMINE THE STEPS THAT SHOULD BE TAKEN TO ESTABLISH A UNIFORM ACCOUNT IDENTIFICATION SYSTEM IN LIGHT OF THE REPORT.

4) Options Clearing Corporation Position Adjustments

The Options Study has found that surveillance information currently available from the Options Clearing Corporation ("OCC") may be inadequate to detect abuses in the position adjustment process. Position adjustments may be used to accomplish improper purposes such as trade reversals, opening transactions by customers or firms in restricted options, and the avoidance of public priority rules for limit orders and off-floor

OCC for several legitimate reasons: To correct errors and omissions that may occur when the terms and parties to an options trade are entered into the computers of the firms for clearing purposes; to transfer accounts between two clearing firms; or to adjust records when one clearing firm executes and compares trades for another firm on an options exchange of which the second firm is not a member.

The OCC has undertaken to improve the surveillance information that is available with respect to position adjustments. By the end of the first quarter of 1979, the OCC will separately identify and distinguish all position adjustments involving transfers of accounts and adjustments that occur because a firm is not a member of the exchange on which a transaction that the firm cleared was effected. The OCC will also prohibit adjustments between clearing firms and will code and identify certain types of adjustments. The Options Study believes that these changes will substantially reduce the potential for abusing the adjustment process and will improve the ability of the self-regulatory organizations to monitor adjustments.

Accordingly, the Options Study recommends:

> THE OCC SHOULD IMPLEMENT ITS PROPOSED REVISIONS IN THE POSITION ADJUSTMENT PROCESS AS SCHEDULED. THE OCC SHOULD ALSO STUDY THE FEASIBILITY OF FURTHER REDUCING THE NUMBER OF POSITION ADJUSTMENTS BY REQUIRING ITS MEMBERS TO RECONCILE THEIR ACCOUNTS TO OCC RECORDS ON A DAILY BASIS AND BY IMPOSING A SURCHARGE ON FIRMS THAT SUBMIT AN EXCESSIVE NUMBER OF ADJUSTMENTS. THE RESULTS OF SUCH A STUDY SHOULD BE SUBMITTED TO THE DIVISION OF MARKET REGULATION WITHIN NINETY DAYS.

5) The Sharing of Surveillance Information and the Allocation of Regulatory Responsibility

The Options Study observed a need for greater coordination of self-regulatory surveillance programs and for the sharing of surveillance information. The Options Study has discussed these matters with the self-regulatory organizations with a view toward

representatives of the options exchanges, the NYSE, the National Association of Securities Dealers ("NASD"), the OCC, and the Boston Stock Exchange (collectively the "Self-Regulatory Conference" or the "Conference") met to discuss the --

> need for the creation of an integrated regulatory system among the [self-regulatory organizations] which would enhance total industry regulatory capability by coordinating and interfacing existing regulatory data and programs through the sharing of available information, improvement of regulatory techniques, [and] the allocation of regulatory responsibility. . . . 16/

The members of the Conference "acknowledge that the establishment of a more fully integrated regulatory system is both necessary and desirable as a means of establishing more efficient and effective regulation which may be cost-effective to the industry and achieve minimum standards of regulation on an industry wide basis thus assuring the protection of public investors." 17/

During their working sessions, the members of the Self-Regulatory Conference identified all market surveillance reports and information presently available and reached a "consensus that the sharing of data

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16/ Letter to Richard Teberg, Director, Special Study of the Options Markets, from the Self-Regulatory Conference, dated October 6, 1978, at p. 2.

17/ Id., at p. 3.

. . . is both needed and desired." 18/ They specified the surveillance information that they would like to receive from each other on a routine, automated basis and agreed generally to share all surveillance information. In addition, they agreed to consider principles for allocating surveillance responsibilities among themselves and agreed to continue their meetings to implement their information sharing plans and "to allocate additional responsibilities with respect to matters arising from inter-market regulatory problems and to further eliminate regulatory duplication." 19/ They also invited the Commission to send a representative to future meetings. The Options Study believes that implementation of the initiatives that the Conference has taken is necessary to assure that self-regulatory surveillance programs are maximally effective.

Accordingly, the Options Study recommends:

> THE COMMISSION SHOULD CLOSELY MONITOR THE EFFORTS OF THE SELF-REGULATORY ORGANIZATIONS TO SHARE SURVEILLANCE INFORMATION AND COORDINATE SELF-REGULATORY ACTIVITIES. THE COMMISSION SHOULD ACKNOWLEDGE BY LETTER THE FORMATION OF THE CONFERENCE AND SUGGEST THAT THE USE OF SECTION 17(d)(2) OF THE ACT AND RULE 17d-2 THEREUNDER TO ALLOCATE SURVEILLANCE RESPONSIBILITIES AMONG THE SELF-REGULATORY ORGANIZATIONS IS APPROPRIATE AND DESIRABLE. IN ADDITION, THE COMMISSION SHOULD SEND A REPRESENTATIVE TO FUTURE MEETINGS OF THE CONFERENCE. THE COMMISSION SHOULD ALSO SEEK TO COORDINATE ITS OWN SURVEILLANCE OPERATIONS WITH THOSE OF THE SELF-REGULATORY ORGANIZATIONS.

18/ Id., at p. 4.

19/ Id., at p. 12.

6) Investigation and Enforcement

The detection of trading that may be inconsistent with the federal securities laws cannot, however, be the end of surveillance. When such trading is detected, it must be investigated to determine whether the Exchange Act or self-regulatory organization rules have been violated. Moreover, where violative conduct is found, the federal securities laws and self-regulatory organization rules must be enforced and the conduct sanctioned with a view toward punishing the violator and deterring future violations. The Options Study's inspections of the options exchanges revealed significant differences in the thoroughness and effectiveness of their investigation and enforcement programs.

Generally, CBOE and PSE investigations were complete and adequately documented. At the PHLX, on the other hand, the extent of investigatory and enforcement efforts was difficult to evaluate because much of the investigatory process was informal and undocumented.

Accordingly, the Options Study recommends:

> THE PHLX SHOULD PROVIDE COMPLETE DOCUMENTATION WITH RESPECT TO ROUTINE SURVEILLANCE FUNCTIONS AND INVESTIGATIONS THAT THAT EXCHANGE PERFORMS. SUCH DOCUMENTATION IS NECESSARY TO ASSURE THAT THE PHLX IS CARRYING OUT ITS STATUTORY RESPONSIBILITIES PROPERLY.

The Options Study's inspection of the AMEX revealed that trading practices that may have been inconsistent with the Exchange Act or AMEX rules were often detected and investigated. Subsequently, however, the AMEX staff closed many cases with no action even though the circumstances suggested that a violation may have occurred. The Options Study found the AMEX case closing procedures troublesome because AMEX cases were seldom formally prepared and, perhaps as a result, factual and legal argument and analysis were not as precise or thorough as the Exchange Act requires. In addition, the AMEX staff often closed cases because it was of the view that a panel of AMEX members would not impose disciplinary sanctions under the circumstances of the case. As a result, the AMEX staff is effectively able to set the legal and ethical standards for trading conduct on the AMEX floor with no involvement of the AMEX membership. Recently, however, the AMEX undertook to form a special committee of its Board of Governors, to review, among other things, all investigative and enforcement activities of the staff.

Accordingly, the Options Study recommends:

> THE AMEX SHOULD FORM A SPECIAL COMMITTEE OF ITS BOARD OF GOVERNORS THAT WILL REVIEW THE INVESTIGATION AND ENFORCEMENT ACTIVITIES OF THE EXCHANGE. THE COMMITTEE SHOULD BE COMPOSED, AS THE AMEX SUGGESTED, OF FLOOR AND NONFLOOR MEMBERS, EXCHANGE OFFICIALS AND A REPRESENTATIVE OF THE PUBLIC. IN ADDITION TO ITS GENERAL REVIEW,

> THE COMMITTEE SHOULD SPECIFICALLY EXAMINE, AT LEAST EVERY SIX MONTHS, EVERY INVESTIGATIVE FILE IN WHICH THE INVESTIGATIVE AND ENFORCEMENT ACTIVITIES OF THE STAFF HAVE BEEN COMPLETED. THE FILE SHOULD IDENTIFY THE REASONS THAT THE INVESTIGATION WAS INITIATED, THE STEPS THAT WERE TAKEN TO INVESTIGATE THE MATTER, THE CONCLUSIONS THAT WERE REACHED CONCERNING EACH ASPECT OF THE POTENTIALLY VIOLATIVE CONDUCT, THE RATIONALE FOR EACH CONCLUSION, AND FULL DOCUMENTATION TO SUPPORT THE RESULT.
>
> FURTHER, COMMISSION INSPECTIONS OF THE AMEX SHOULD EMPHASIZE A REVIEW OF CASE FILES THAT ARE CLOSED AFTER INVESTIGATION TO ASSURE THAT AMEX ENFORCEMENT RESPONSIBILITIES ARE PROPERLY CARRIED OUT.

An inspection of the MSE options surveillance program caused the Options Study concern in two areas. First, although MSE documents indicated the exchange had detected numerous instances of trading that may have been inconsistent with the Exchange Act or MSE rules, no records were maintained indicating whether any subsequent investigation was done. As a consequence, it is impossible to determine the regularity, adequacy, or extent of investigations of potential improprieties that the MSE surveillance system detected. Second, the case files that the Options Study reviewed demonstrated that MSE investigations that were conducted were often incomplete and concluded prematurely.

Accordingly, the Options Study recommends:

> THE COMMISSION SHOULD CONDUCT A COMPLETE INVESTIGATION OF THE MSE OPTIONS SURVEILLANCE PROGRAM. THE INSPECTION SHOULD SEEK TO DETERMINE WHETHER THE MSE HAS THE ABILITY TO ENFORCE COMPLIANCE WITH THE ACT AND MSE RULES WITH RESPECT TO OPTIONS TRADING ON THE MSE FLOOR.

b. Broker-Dealer Oversight

Each of the self-regulatory organizations has monitoring, investigation, examination, and disciplinary programs to assure that their broker-dealer member firms comply with the federal securities laws and the self-regulatory organization rules governing, among other things, selling practices. The Options Study reviewed the broker-dealer sales practice programs and investigative and enforcement files at the options exchanges and the NYSE and conducted interviews with officials of self-regulatory organizations regarding the operations of these programs. The Options Study found that broker-dealer oversight programs of the self-regulatory organizations have been inadequate to assure the protection of the public.

The self-regulatory organizations, in their oversight of member firms, fail to use public customers as a source of valuable regulatory information and to collect relevant data from one another. Public customers are not routinely questioned in conjunction with examinations and investigations of member firms and their associated persons and,

therefore, self-regulatory organizations frequently terminate investigations prematurely or fail to pursue potential violations uncovered by routine examinations. There is also no routine exchange among self-regulatory organizations of essential compliance information, such as the results of examinations, investigations and informal disciplinary actions. Accordingly, the self-regulatory organizations in many instances have an inaccurate perception of the conduct of their member firms.

Much valuable information available from member firms is not assembled and evaluated by self-regulatory associations, primarily because the self-regulators have not sought access to such data. Moreover, useful information available from government agencies is neither sought nor used routinely.

Investigations and examinations of retail sales practices by the self-regulatory organizations normally concentrate only on detecting member firm failures to follow record-keeping procedures established by the rules of the self-regulatory organizations governing, for example, the opening of accounts and approving of transactions. Self-regulatory examination and investigative procedures are not adequately designed or utilized to detect substantive violations, such as use of deceptive sales materials, recommendations of options transactions unsuited to the customer, and excessive or unauthorized trading in customer accounts.

In conducting an inquiry arising out of a customer's complaint or a notification that a registered representative's employment has been terminated because of a possible rule violation, the self-regulatory organizations limit their inspection to the specific, often narrow, issues raised by the complaint or termination notice. These inspections do not consider whether other customer accounts of the same registered representative may have experienced problems similar to those of the complaining customer. Nor do these inspections consider whether possibly related rule violations may have occurred which, for one reason or other, may not have been articulated in the customer's complaint or in the registered representative's termination notice. Moreover, the self-regulatory organizations are generally reluctant to resolve factual disputes between customer and firms, even though this task normally is necessary to determine whether misconduct has occurred.

Disciplinary action taken by the self-regulatory organizations has been ineffective in deterring future violations. Non-public letters of caution or other informal sanctions are too often imposed in cases involving serious violations or injury to public investors. The self-regulatory organizations also allow their member firms to commit repeated rule violations without decisive remedial action.

The Options Study discussed these and other concerns with the self-regulatory organizations. The Self-Regulatory Conference agreed that "it should be possible to establish some industry-wide objectives for the conduct of a [broker-dealer firm] examination so as to insure the protection of investors, avoid regulatory duplication, and eliminate regulatory voids". The Conference also agreed to consider establishing programs "to promote a sharing of relevant information about broker-dealer compliance activities and to assist in the execution of complete, comprehensive and thorough examinations of such firms." 20/ Toward this end, the Conference agreed "that a [central] repository could be utilized to provide each self-regulatory organization with more information than is presently utilized for purposes of registration of personnel, customer complaints, investigations and examinations." 21/ This central repository would include "at least all information regarding [registered representative] registration and termination, customer complaints, and formal actions taken by [the self-regulatory organizations] and other regulatory bodies...." 22/ The Options Study believes that these initiatives by the Self-Regulatory Conference are constructive and that they should be implemented as soon as possible.

20/ Id. at pp. 7-8.

21/ Id. at p. 8.

22/ Id. at p. 9.

The Options Study believes that additional initiatives are necessary to remedy the deficiencies summarized above, and to establish minimum standards for the performance of self-regulatory enforcement programs, and therefore recommends:

> SELF-REGULATORY ORGANIZATIONS SHOULD BROADEN THE SCOPE OF THEIR EXAMINATIONS AND INVESTIGATIONS AND ROUTINELY QUESTION PUBLIC CUSTOMERS IN ORDER TO RESOLVE DISPUTED ISSUES OF FACT, TO DETERMINE WHETHER THERE MAY HAVE BEEN A VIOLATION OF THE SECURITIES LAWS OR APPLICABLE RULES, AND TO VERIFY INFORMATION OBTAINED FROM ANOTHER SOURCE.
>
> SELF-REGULATORY ORGANIZATIONS SHOULD DEVELOP WAYS TO SHARE RELEVANT COMPLIANCE INFORMATION AND MORE EFFECTIVELY ALLOCATE RESPONSIBILITY FOR BROKER-DEALER OVERSIGHT AMONG THEMSELVES.
>
> SELF-REGULATORY ORGANIZATIONS SHOULD RESTRICT INFORMAL DISCIPLINARY ACTIONS TO CASES IN WHICH PUBLIC CUSTOMERS HAVE NOT BEEN INJURED AND IN WHICH RULE VIOLATIONS ARE MINOR OR ISOLATED.
>
> SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR RULES TO PERMIT THEM TO ORDER RESTITUTION TO INJURED INVESTORS AS A SANCTION IN APPROPRIATE DISCIPLINARY ACTIONS.

2. Trading Practices

To determine how market professionals use options in connection with investment and trading strategies the Options Study interviewed more than 100 professional stock and options traders.

In addition, the Options Study examined numerous investigative records already established by the Commission and the self-regulatory organizations with regard to questionable trading practices such

as trade reversals, prearranged and fictitious trades, stock/option manipulation and front-running of blocks. The purpose of this effort was to determine whether certain market professionals have access to non-public market information and enjoy other competitive advantages that might be inconsistent with the federal securities laws and whether Commission or self-regulatory organization action is necessary to prevent manipulative or other improper conduct in connection with options trading. The Options Study, however, did not conduct independent investigations or particular trading situations. Nor was the Options Study able to review and analyze trading data or investigations that the self-regulatory organizations initiated in sufficient detail to form the basis for regulatory recommendations. As a result, further study will be required to determine whether specific trading patterns can be identified which should be the subject of proscriptive rules and to formulate appropriate rules where necessary.

a. Professional Trading

Institutional investors generally write call options to limit the risk associated with their stock activities through the premiums received. Other options market professionals, however, employ a variety of trading strategies. These options strategies seek to realize trading profits in diverse ways: (1) speculation that market prices will move either up or down, r stay within a given

range; (2) purchasing options at the bid price and selling at the offer price to profit from the spread between the quotations; (3) trading that reduces positions to a limited or neutral risk posture to profit from the passage of time or from price movements in the underlying stock within a predetermined range; and (4) arbitrage.

The Options Study's review did not reveal that market professionals have competitive advantages that are inconsistent with the Exchange Act or the public interest. Additional information must be gathered, however, if the Commission and the self-regulatory organizations are to understand whether the patterns, relationships, and effects of stock and options trading by market professionals may be inconsistent with the public interest in a manner not currently perceived. In particular, more information is needed regarding patterns of trading near expiration and stock trading activities that might be designed to benefit unfairly pre-existing options positions.

Accordingly, the Options Study recommends:

> THE SELF-REGULATORY ORGANIZATIONS SHOULD USE THE INTEGRATED SURVEILLANCE DATA BASE THAT THEY ARE ESTABLISHING FOR STOCK AND OPTIONS TRADING TO DETECT UNLAWFUL TRADING ACTIVITIES AND CONDUCT APPROPRIATE ENFORCEMENT ACTIONS AND TO IDENTIFY PATTERNS OF STOCK AND OPTIONS TRADING THAT SHOULD BE REGULATED OR PROHIBITED. THE COMMISSION AND THE SELF-REGULATORY ORGANIZATIONS SHOULD WORK TOGETHER TO ESTABLISH PRIORITIES FOR THESE STUDIES AND THE SELF-REGULATORY ORGANIZATIONS SHOULD REGULARLY REPORT THE RESULTS OF THE STUDIES THAT THEY CONDUCT TO THE COMMISSION.

Accordingly, the Options Study recommends:

> THE DIVISION OF MARKET REGULATION SHOULD OBTAIN AND REVIEW ALL INSTANCES OF OPTIONS AND STOCK TRADING WHICH ARE OR HAVE BEEN THE SUBJECT OF INFORMAL OR FORMAL INVESTIGATIONS BY THE SELF-REGULATORY ORGANIZATIONS. THE DIVISION OF MARKET REGULATION SHOULD REVIEW THIS DATA WITH A VIEW TOWARD PROPOSING ANTI-MANIPULATIVE OPTIONS AND STOCK TRADING RULES WHERE APPROPRIATE.

b. Position Limits

Existing options exchange rules prohibit a person from holding more than 1,000 short calls and long puts with respect to any underlying security. Position limit rules were adopted by the options exchanges primarily to minimize manipulative potential and to prevent the accumulation of large options positions that, if exercised, might affect the price of the underlying stock.

The present position limit rules prevent certain larger investors (primarily institutions) from writing calls or buying puts against more than 100,000 shares of stock. As a result, the managers of certain large portfolios do not presently use options because writing options up to existing position limits does not provide significant risk limiting capabilities for such large portfolios. To the extent that large investors own the stock underlying the options they write, they need not purchase stock to deliver on exercise of the calls they write or the puts they buy and, therefore, may not need to effect transactions which will substantially affect stock prices. As a result, a significant

portion of the theory underlying the position limit rules may not be applicable to such covered investors.

Numerous market participants, including professional traders, institutional investors, and self-regulatory organizations, have maintained that the position limit rules should generally be liberalized or otherwise modified. Further, the ability of some self-regulatory organizations to grant their marketmakers exceptions from these rules, and the manner and frequency with which exceptions have been granted, has raised concern that the rules currently have an unequal impact on members of different self-regulatory organizations. It has been suggested that either the rules be made uniform for all market participants or that the self-regulatory organizations be permitted to liberally grant exceptions, especially in instances where a marketmaker might otherwise violate the rule when fulfilling his obligation to trade with public customers.

Accordingly, the Options Study recommends:

> THE DIVISION OF MARKET REGULATION SHOULD UNDERTAKE A COMPLETE REVIEW OF THE POSITION LIMIT RULES OF THE OPTIONS EXCHANGES. THIS REVIEW SHOULD INCLUDE: (1) THE POSSIBILITY OF ELIMINATING POSITION LIMIT RULES, (2) THE FEASIBILITY OF RELAXING POSITION LIMIT RULES FOR (a) ALL MARKET PARTICIPANTS, (b) FOR ACCOUNTS WHICH HOLD FULLY PAID, FREELY TRANSFERABLE SECURITIES OR (c) FOR "HEDGED" POSITIONS, AND (3) WHETHER EXCEPTIONS FROM THE RULES SHOULD BE GRANTED TO OPTIONS SPECIALISTS AND, IF SO, UNDER WHAT CIRCUMSTANCES.

c. Clarification of Trading Rules

Following the commencement of the Options Study, the CBOE issued educational circulars to its members discussing both specific trading activities that may be considered manipulative and the misuse of market information involving those options trades which take place prior to the public dissemination of information concerning a large stock trade. The Options Study believes that this type of educational circular identifies and helps to prevent improper activity, particularly in the area of front-running.

Accordingly, the Options Study recommends:

> ALL SELF-REGULATORY ORGANIZATIONS SHOULD (1) ISSUE INTERPRETATIONS OF THEIR RULES TO MAKE CLEAR THAT FRONT-RUNNING IS INCONSISTENT WITH JUST AND EQUITABLE PRINCIPLES OF TRADE BY ITS MEMBERS AND, (2) TAKE PROMPT DISCIPLINARY ACTION AGAINST THOSE MEMBERS WHO HAVE BEEN FOUND TO HAVE ENGAGED IN FRONT-RUNNING.

The Commission should also take steps to clarify the law when necessary or appropriate. In the area of related stock and options trading, for example, there has been much debate concerning the types of trading that might be considered manipulative. While the Commission has proceeded against intermarket manipulation in reliance upon Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, the applicability of Section 9(a)(2) of the Exchange Act to such activities remains unsettled.

The uncertainty arises because Section 9(a)(2) applies to "a series of transactions in any security ... creating actual or apparent active trading in such security or raising or depressing the price

of such security, for the purpose of inducing the purchase or sale of such security by others." Neither the Commission nor the courts has resolved the question of the applicability of this section to related stock and options trading. The Options Study believes that this issue should be resolved by making it clear that stock transactions effected to benefit options positions fall within the scope of Section 9.

Accordingly, the Options Study recommends:

> THE COMMISSION SHOULD ISSUE AN INTERPRETIVE RELEASE OR INITIATE RULEMAKING PROCEEDINGS SPECIFICALLY TO CLARIFY THAT INTER-MARKET MANIPULATIVE TRADING ACTIVITY INVOLVING OPTIONS AND THEIR UNDERLYING SECURITIES MAY VIOLATE SECTION 9.

Shortly after listed option trading began, the options exchanges adopted so-called restricted options rules which were designed to prevent unwarranted speculation in deep out-of-the-money options. Restricted options rules tend to limit legitimate trading activities of some options customers. The Options Study believes that improvements in the customer suitability and its enforcement may, at a future date, allow the elimination of the restricted options rules. Accordingly, the Options Study recommends:

> THE DIVISION OF MARKET REGULATION SHOULD CONSIDER THE ELIMINATION OF THE RESTRICTED OPTION RULES AS SOON AS THE OVERALL EFFECTIVENESS OF THE OPTIONS STUDY'S SUITABILITY RECOMMENDATIONS CAN BE EVALUATED.

3. Selling Practices

To examine the manner in which options transactions are recommended to public customers, the Options Study reviewed public complaint

letters, retail sales practice examinations conducted by the Commission and the self-regulatory organizations and additional data, including the responses to a detailed questionnaire, provided by broker-dealers. Significant problems related to options selling practices were found. These problems included solicitation of options transactions unsuited to the customer; excessive and unauthorized trading in customer options accounts; inadequately trained registered representatives and supervisors; deceptive advertising and sales literature; and irregularities in options exercise practices.

a. Customer Protection

Both brokerage firms and self-regulatory organizations need to improve their procedures to prevent sales practice abuses. As a first step, broker-dealers and the self-regulatory organizations should take steps to place the customer in a better position to detect sales practice abuses in his own account. If the customer does not have in his possession essential information about his own account in a form he can easily understand, the customer can not detect and prevent improper activities in which his registered representative might engage.

1) The OCC Prospectus

One of the major regulatory safeguards intended to protect options customers from possible abuses is a prospectus required by the Securities Act of 1933 ("Securities Act"). The options prospectus is published

by the Options Clearing Corporation ("OCC"), which technically is the issuer of all listed options. Exchange rules require that this prospectus be delivered to every customer at or prior to the time his account is approved for options trading. The prospectus contains 56 printed pages describing, in considerable detail, information about options, their risks and the mechanics of options trading.

The current options prospectus was drafted to meet the requirements of the Commission's general registration form, Securities Act Form S-1. This form is used when no other specialized form has been designated. While the OCC has gone to considerable effort to simplify the language of the options prospectus, the Form S-1 is not designed to meet the needs of both options buyers and sellers. The Options Study has concluded that information concerning listed options should be disclosed to investors in a manner readily understandable to a reader with no financial training and that information about options and the trading markets for options should be separated from information about the OCC.

Compliance by the OCC with the Securities Act can be satisfied by the filing of a special form of registration statement and prospectus designed for OCC as the issuer of options and adopted pursuant to the Commission's authority under the Securities Act. This special form would include information relating to the OCC, including a description of its business and financial reports.

To provide investors with an appropriate disclosure document, a new document prepared by OCC would be required under the Exchange Act to be delivered at or prior to the time of an options customer opens an account. This document, designed for persons without financial training, would provide investors with a simple description of the risks and uses of put and call options. This new document should include a glossary of terms; a description of (i) the risks of options trading, (ii) the fundamental uses of options trading, (iii) the terms of options, and (iv) the mechanics of buying, wiring and exercising options; and a simplified discussion of transaction costs, margin requirements and tax consequences of option trading.

The effect of these recommendations would be to relieve OCC from liability under Section 11 of the SEcurities Act for disclosures relating to a description and uses of options and the mechanics of the options trading markets, matters with respect to which OCC has no special expertise or control. At the same time, potential options traders would be furnished with a disclosure document designed specifically for their needs and, in particular, for the needs of those investors with little or no financial training.

Accordingly, the Options Study recommends.

> THE COMMISSION SHOULD ADOPT A SPECIAL REGISTRATION FORM UNDER THE SECURITIES ACT FOR OCC WHICH WOULD NOT REQUIRE OCC TO DESCRIBE INFORMATION ABOUT OPTIONS TRADING AND SHOULD EXERCISE ITS AUTHORITY UNDER THE EXCHANGE ACT TO REQUIRE THAT A DISCLOSURE DOCUMENT

> FILED UNDER THE EXCHANGE ACT DESCRIBING OPTIONS, THEIR RISKS, AND THE MECHANICS OF OPTIONS TRADING BE PREPARED BY OCC AND BE DELIVERED BY BROKER-DEALERS TO EACH OPTIONS CUSTOMER AT OR PRIOR TO THE TIME THE CUSTOMER OPENS AN OPTIONS ACCOUNT.

2) Customer Suitability

Another safeguard designed to protect the customer from unethical or illegal selling practices is the brokerage firm's own evaluation of the customer's suitability to trade in options. The self-regulatory organizations have adopted rules establishing suitability standards which are to be applied by broker-dealer firms to prevent the firms and their registered representatives from making unsuitable recommendations to customers. The suitability rules of the options exchanges, however, do not match the suitability warning in the prospectus.

The current options prospectus states on the cover page in bold face type:

> Both the purchase and writing of Options involve a high degree of risk and are not suitable for many investors. Such transactions should be entered into only by investors who have read and understand this prospectus and, in particular, who understand the nature and extent of their rights and obligations and are aware of the risks involved.

The options exchanges do not require, as does the prospectus, that the customer understand the risks of recommended options transactions, except when the particular recommendation is to write (sell) uncovered calls or to write put options.

This important distinction can be seen in the general suitability rule of the CBOE. This rule, which is similar to those of the other options exchanges, requires only that a registered representative who recommends options transactions to a customer:

> shall have reasonable grounds for believing that the recommendation is not unsuitable for such customer on the basis of the information furnished by such customer after reasonable inquiry as to his investment objectives, financial situation and needs, and any other information known [to the broker-dealer firm or registered representative]. (Emphasis added.)

Only when the registered representative's recommendation is to write uncovered call or put options does the CBOE rule require that the customer should understand the risks involved. Under this paragraph of the rule, writing uncovered calls or writing puts is deemed unsuitable unless:

> upon the information furnished by the customer, the person making the recommendation has a reasonable basis for believing at the time of making a recommendation that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of such transaction, and such financial capability as to be able to carry such position in the option contract. (Emphasis added.)

The Options Study believes that a customer should be made aware, on an on-going basis, of the risks of any and all options transactions undertaken by the customer and that a brokerage firm should not be permitted to recommend any opening options transaction to a customer unless

the firm reasonably expects that the customer is capable of both evaluating the risks and bearing the financial burden of those risks.

To insure that this standard is met on a continuing basis, information concerning a customer's current financial resources, needs, and sophistication should be obtained by the brokerage firm. This information should be utilized in determining the suitability of options trading for a customer, first at the time a customer opens an account and again before a registered representative recommends a new, more complex, or riskier options strategy than the type for which the customer has already been approved.

Without accurate and complete data about a customer's financial position and objectives, a brokerage firm cannot make well founded decisions concerning the suitability of options trading for that customer. Too often, a registered representative, without detection, fabricates suitability information about prospective new options customers solely in order to secure from his supervisor the required approval of transactions for an account. The State of Wisconsin has resolved this problem by requiring that the management of a brokerage firm send to each new optior ner a copy of the completed suitability information form relating hat customer. This process assures the customer an opportunity to review the information form, outlining his financial objectives and position, which the registered representative has already filled out.

Accordingly, the Options Study recommends:

> THE SELF-REGULATORY ORGANIZATIONS SHOULD REVISE THEIR OPTIONS SUITABILITY RULES TO PROHIBIT A BROKER-DEALER FROM RECOMMENDING ANY OPENING OPTIONS TRANSACTIONS TO A CUSTOMER UNLESS THE FIRM HAS A REASONABLE BASIS FOR BELIEVING THAT THE CUSTOMER IS ABLE TO EVALUATE THE RISKS OF THE PARTICULAR RECOMMENDED TRANSACTION AND IS FINANCIALLY ABLE TO BEAR THE RISKS OF THE RECOMMENDED POSITIONS. THE SELF-REGULATORY ORGANIZATIONS SHOULD FURTHER AMEND THEIR RULES TO REQUIRE:
>
> — THAT CUSTOMER INFORMATION FORMS BE STANDARDIZED AND REVISED TO INDICATE THE SOURCE OF SUITABILITY INFORMATION ABOUT THE OPTIONS CUSTOMER;
>
> — THAT THE MANAGEMENT OF EACH MEMBER FIRM SEND TO EVERY NEW OPTIONS CUSTOMER FOR HIS VERIFICATION A COPY OF THE FORM CONTAINING THE CUSTOMER'S SUITABILITY INFORMATION AND THAT THE CURRENCY OF INFORMATION ON SUCH FORMS BE CONFIRMED SEMI-ANNUALLY;
>
> — THAT MEMBER FIRMS BE PROHIBITED FROM RECOMMENDING OPENING OPTIONS TRANSACTIONS TO CUSTOMERS WHO REFUSE TO PROVIDE SUITABILITY INFORMATION, AND FOR WHOM THE FIRMS DO NOT OTHERWISE HAVE INDEPENDENTLY VERIFIED INFORMATION SUFFICIENT FOR THE SUITABILITY DETERMINATION; AND
>
> — THAT MEMBER FIRMS ADOPT ADDITIONAL SAFEGUARDS FOR THE PROTECTION OF EACH OPTIONS CUSTOMER IN WHOSE ACCOUNT DISCRETION IS TO BE EXERCISED.

3) Opening Account Statements

Even if a customer is able to understand the risks of his options transactions, he may be confused by his account statement. Account statements reflecting options transactions sent by brokerage firms to their customers are frequently difficult to understand. Not only may a customer have difficulty understanding the options transactions