

5. Suitability - A Final Note

The Options Study believes that the changes recommended in this section, if adopted, will improve significantly brokerage firms' controls over the suitability of listed options trading for customers. Certain of the suitability abuses encountered by the Options Study, however, indicate far more than inadequacies in the current control systems of brokerage firms. For instance, the Options Study found the following suitability cases:

- As the result of an automobile accident resulting in a head injury, one individual developed serious emotional problems and memory difficulties which prevented him from holding a job. He had been fired from more than 20 jobs and his total annual income consisted of income from the accident compensation award and approximately \$5,000 in social security disability payments. This customer's registered representative invested the customer's entire assets in an aggressive options trading program which resulted in losses of more than \$70,000 over a two year period. The registered representative showed complete disregard for his customer's limited income, mental incapacity and dependency upon him and stated in one internal memorandum that the customer: "has enough assets to guarantee payment of whatever his little mind can logically dream up".
- Another customer was completely unsophisticated about financial matters and had no prior experience in the market other than an investment in a mutual fund. She had an eighth grade education and her husband a fourth grade education. At the advice of her registered representative, she invested her entire \$36,000 portfolio in a margin account trading options. She suffered substantial losses.

- A retired couple with a fixed income of approximately \$12,000 a year had a portfolio of New York Stock Exchange listed stocks which they acquired over a period of about 25 years, some of which they had given to their only daughter who was almost completely disabled. The daughter had an annual income of less than \$5,000 and a net worth of about \$45,000. A registered representative persuaded both the daughter and her parents to sell a substantial part of their stock and to enter into a program of writing calls covered by warrants, a risky strategy which resulted in significant losses in both accounts.

Cases such as these, and cases of repeated violations, can occur only where brokerage firms and their employees ignore the obligations imposed on them by the suitability doctrine and act irresponsibly. In the last example above, when questioned by a self-regulatory organization about its failure to prevent its registered representative from making such obviously unsuitable options trades, the brokerage firm responded that its supervisors had no obligation to know of the specific physical condition of the customer and that reporting or recording the customer's known physical disability would be an infringement of the customer's rights.

Another major brokerage firm was sanctioned by the Commission in 1978 for willful violations of the antifraud provisions of the Federal securities laws in a case in which customers were permitted to engage in unsuitable options trading and the firm's suitability screening procedures were found to be ineffective. An inspection of the firm's options trading activities within six months after the Commission's enforcement proceeding indicated that as many as

twenty-five percent of the firm's options customers still were trading options at strategy levels more advanced than those approved by the firm.

The Options Study believes that the self-regulatory organizations and the Commission should take all steps necessary to focus the attention of brokerage firms on their responsibilities toward their options customers under the suitability doctrine. The rule changes recommended here should ease this enforcement effort by improving recordkeeping procedures and by providing critical data in a form usable to both firms and regulators. Without such an effort, however, violations will continue, the rule changes recommended will be meaningless, and salespersons, like the one in the following recorded conversation, will continue to put customers, including those who financially do not belong in options trading at all, into such clearly unsuitable options positions as the one transacted below.

EXCERPT FROM A REGISTERED REPRESENTATIVE - CUSTOMER CONVERSATION

SALESMAN: All right. Now ... we put a naked [call option position]* into your account today.

Tried to call you, but I guess you were at school.

* Selling "naked" or uncovered call options is one of the most risky undertakings in which an options customer can engage. It involves selling an option entitling the buyer to demand delivery of stock the seller does not own.

CUSTOMER: No, I didn't have any classes. I was trying to get a credit card.

SALESMAN:What kind of credit card were you trying to get?

CUSTOMER: Well it was at [a bank], trying to talk him into giving me credit for a ... Master Charge or a Visa. Now they sent me back a rejection notice, and I'd gotten one from Bank America said one thing, and [the bank] said I didn't have enough steady income, so ... I took in the statement from [your brokerage firm].... He said he was going to look it over this afternoon and call me back. It's not a steady income I guess, until you have two or three years of it.

SALESMAN: It really is a bummer. How much longer of school do you have left? Or don't you know?

* * *

CUSTOMER: I could graduate with a degree in anthropology in June, if I wanted to, but I'm more or less a professional student, because I don't see any job at the end of the line.

SALESMAN: Not in anthropology. Okay. One thing you might want to do, you might want to put my name down, for instance, as a credit reference if you fill out another form.

CUSTOMER: Well, it's kind of a standard thing. I did put of course [your brokerage firm] down

SALESMAN: Because, see, bankers are funny people, and usually the guy that's looking at this is some clerk who makes, you know, four hundred dollars a month, and they gave him a form in front of him, and it said, unless this answer is answered this way, and this answer is answered that way, you reject the guy. You know how it works. So ... maybe we can talk to the clerk and let him know what's happening.

*

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SALESMAN: Okay. Anyway, getting back to the naked [call option position] we put in your account today...

The customer above eventually lost \$6,000, a substantial amount of which was in commissions paid to the brokerage firm and this particular salesman.

D. DISCLOSURE DOCUMENTS

In many cases, the options customer is the person best motivated to protect his own financial interests and to oversee his own options trading. However, unless the customer has sufficient information, in an understandable form, with which to assess both the risks of options trading and the status of his account, he cannot adequately guard his own interests. The rules of the Commission and the self-regulatory organizations require that an options customer be furnished with several documents intended to inform him, at the time he opens an options account, of the risks of options trading and, once he has begun trading, of the status of his account. These documents include a current OCC prospectus, customer account statements, and written confirmations of each options transaction in the customer's account. The Options Study has found that many customers are unable to understand the prospectus and their account statements. Not only are these documents frequently too complicated or too cryptic, they also appear to be ineffective as safeguards both for the customer who is drawn to options by a misleading sales presentation and against the registered representative who is engaged in improper activity.

1. Account Statements

In order to properly oversee his options account, a customer must first be able to understand his account statement. The Options Study has found, however, that many customers, and even some supervisors,

cannot understand these monthly statements well enough to calculate easily the status of the account. Sometimes this difficulty results from the complexity of options trading. At other times, however, lack of understanding is the result of insufficient disclosure on customer account statements.

As a result of the inability of many customers to understand their account statements, registered representatives have been able to mislead customers about the profitability of their options transactions sometimes for months at a time. These deceptive activities would have been detected easily by the supervisors of the firm had the customer's options account statement disclosed essential information more fully and clearly. In one case, the Options Study found that a registered representative had directed his firm to send to several of his options customers monthly withdrawal checks, siphoned from their own existing equity reserves but designed to appear to the customer as "profits" from his options trading program. All the while, each customer's account equity was dwindling even further as a result of losses incurred in the salesman's trading programs, losses which were not disclosed by the account statements. A monthly account statement which disclosed current equity in a customer's account would have prevented, or at least discouraged, this deceptive practice.

Recent improvements in the account statement form produced by some firms have proved to be of help to those firms' customers. For example,

one customer, who had been convinced by a registered representative at a national brokerage firm to engage in exotic options strategies for five months, described his experience with unintelligible brokerage firm statements prior to August of 1977:

Before I knew it, I was receiving a large number of confirmation slips for both opening and closing spread transactions. I was thoroughly confused by all the confirmations. ... I was unable to follow the trading nor was I able to understand the monthly account statements.

In August of 1977, however, this investor's brokerage firm began disclosing account equity on customer monthly statements. The same investor testified about the effect of these disclosures for him:

At the end of July, I agreed to put on some straddles in order to eliminate my margin balance. When I received my August 31, 1977 account statement, I discovered that my portfolio value had decreased from \$93,000 to \$67,000. At this time I decided to talk with [my registered representative] about the condition of my account with the manager of the office present.

The Options Study encountered other cases where customers similarly learned of substantial losses in their options accounts only after their accounts were transferred to brokerage firms which disclosed the current value of the options account.

Very few firms in the industry group sample provide account equity information on customer account statements and even fewer include commission information on such statements. Several firms

do have commission information on internal copies of account statement forms, but only one firm sends this information to customers. No firm in the sample group provides on the account statement the name of a supervisor whom the customer might call with questions about his account. The table below sets out the practices of the industry group sample with regard to other customer account statement disclosures:

ACCOUNT STATEMENT SHOWS	<u>YES</u>	<u>NO</u>
Commissions attributable to each transaction during period	2%	98%
Current price of each security at end of period	12%	88%
Current value of portfolio at end of period	9%	91%
Change in portfolio value during period	0%	100%

All firms in the industry group sample disclose the amount of margin loans outstanding and interest expenses incurred during the period covered by the statement, as required by Exchange Act Rule 10b-16.

Exhibit A is an expanded version of a customer's monthly statement, prepared by a major brokerage firm for one its active options accounts for the month of May 1978. Registered representatives of the firm routinely receive this copy of their customers' monthly statements

which include all of the following items: interest expenses (year-to-date); aggregate commissions (year-to-date); account equity (marked to market); equity variation since last statement date; commissions attributable to each transaction; and the current market value of each position in the account. The customer, however, is sent a copy of the statement which includes none of this particular information. As can be seen from Exhibit A, the registered representative receives the whole account sheet, while the customer is sent only that information to the left of the arrow.

For an options customer to be able to oversee his own account he must receive an account statement which allows him to determine, by simple inspection, both the current value of his account and any change in his account value during the period covered by the statement. It should disclose all costs incurred during the period including commissions attributable to each transaction, and, of course, it should show the amount of any margin loans outstanding.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD ADOPT RULES REQUIRING THE OPTIONS CUSTOMER'S ACCOUNT STATEMENT TO SHOW THE EQUITY IN THE CUSTOMER'S ACCOUNT WITH ALL OPTIONS AND OTHER SECURITIES POSITIONS MARKED TO MARKET AND THE YEAR TO DATE PROFIT OR LOSS IN THE ACCOUNT CLEARLY SHOWN. THE OPTIONS CUSTOMER'S ACCOUNT STATEMENT SHOULD ALSO SHOW THE AMOUNT OF MARGIN LOANS OUTSTANDING AS WELL AS COMMISSION CHARGES APPLICABLE TO EACH TRANSACTION AND OTHER EXPENSES PAID OR PAYABLE, FOR THE PERIOD COVERED BY THE ACCOUNT STATEMENT AND YEAR TO DATE.

EXHIBIT A

Client Statement

Account Data		Balance Summary		Statement Date/Interest		Earnings Summary		I.E. Summary	
Account No.	I.E. No. Page	Combined Acc't Opening Bal.	Combined Acc't Closing Bal.	Statement/Interest Period		Dividend YTD	4,524		
		5,312.10CP	501,44CB	05/01 - 05/26/78		1,617.50	SMA Cash Available	Interest YTD	
Social Security/ID No.		Short Acc't Opening Bal.	Short Acc't Closing Bal.	Interest Rate	Interest Charge	Road Interest YTD	65,641	2.55	
							Cash Account Balance	Commission YTD	
Investment Executive Name		Paid Portfolio Value	Buying Power	Average Daily Balance		Abnormal Interest YTD		1,123.71	
		124,000.00	131,282.00				Equity	% Variation	Exit Statement Date
							124,541	-	1204 30 78

Date	Bought Rec'd or Lon.	Sold Del'd or Short	Description	Type	Price or Entry	Amount Charged	Amount Credited	Commission Mkt. Value	Legal Title Name Trust
05 01 78			CITICORP	26	DIV-RECD		116.00		
05 01 78			P C A CORP	26	DIV-RECD		140.00		
05 01 78			UPJOHN CO	26	DIV-RECD		66.00		
05 01 78	1		CALL EASTMAN KODK OCT 45 CBOE	26	7 5/8	788.36		25.86	
			EXP 10/21/1978						
			CLOSE						
05 01 78		1	CALL EASTMAN KODK JAN 50 CBOE	26	5 3/8		512.48	25.00	
			EXP 01/20/1979						
			OPEN						
05 02 78		4	CALL PEPSCO INC JAN 30 CBOE	26	1 7/8		696.31	53.66	
			EXP 01/20/1979						
			OPEN SV 4-28-78						
			AS OF 04/27/78						
05 02 78		3	CALL GOODYEAR OCT 20 ANEX	26	1/2		136.13	13.86	
			EXP 10/21/1978						
			OPEN						
05 04 78		2	CALL AM HOSP SPLY NOV 30 CBOE	26	1 3/4		316.54	33.44	
			EXP 11/16/1978						
			OPEN						
05 07 78	200		AMERICAN HOSPITAL SUPPLY CORP	26	28 3/8	5,788.24		113.24	
05 15 78	2		CALL STD OIL IND MAY 50 CBOE	26	13/16	177.52		15.02	
			EXP 05/20/1978						
			CLOSE						
05 23 78	4		CALL FEHIZOIL JAN 30 CBOE	26	OPT				
			EXP 01/21/1978						
05 23 78	4		CALL FEHIZOIL JAN 30 CBOE	26	1 7/8		696.31	53.66	
			EXP 01/21/1978						
			CORRECTION IN DESCRIPTION						
			SV 4-28-78 OPEN						

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EXHIBIT A (continued)

Client Statement

Account Data			Balance Summary		Statement Date/Interest		Earnings Summary		I.E. Summary	
Account No.	YI No.	Page	Combined Acc't. Opening Bal.	Combined Acc't. Closing Bal.	Statement/Interest Period		Dividend YTD		EMA Cash Available	Interest YTD
					05/01 - 05/26/78					
Secret Security/ID No.	Sheet Acc't. Opening Bal.		Sheet Acc't. Closing Bal.		Interest Rate	Interest Charge	Bond Interest YTD		Cash Account Balance	Penalties YTD
CONTINUED										
Investment Executive Name	Paid Portfolio Value		Buying Power		Average Daily Balance		Unrealized Interest YTD		Equity	% Variation
										Last Statement Date

Date	Buy/Sell	Rec'd or Lnds	Sold Bal'd or Short	Description	Type	Price or Entry	Amount Charged	Amount Credited	Commission Fmt. Value	Legal Title Name Trust
				DUE 1-20-1979						
				2 CALL CITICOPP JUL 25 CBOE	26	.75			150-	
				DUE 7-22-1978						
				2 CALL CITICOPP JAN 25 CBOE	26	2.06			412-	
				DUE 1-20-1979						
				1 CALL GENL MOTORS JUL 60 CBOE	26	2.25			225-	
				DUE 7-22-1978						
				2 CALL HONEYWELL NOV 45 CBOE	26	11.75			2,350-	
				DUE 11-18-1978						
				1 CALL IBM JUL 240 CBOE	26	24.50			2,450-	
				DUE 7-22-1978						
				2 CALL K MART COPP JUL 25 CBOE	26	1.25			250-	
				DUE 7-22-1978						
				2 CALL K MART CORP JUL 30 CBOE	26	.31			62-	
				DUE 7-22-1978						
				4 CALL PETROZIL JAN 30 CBOE	26	2.12			848-	
				DUE 1-20-1979						
				2 CALL RCA CORP JAN 30 CBOE	26	1.75			350-	
				DUE 1-20-1979						
				2 CALL RCA CORP OCT 25 CBOE	26	3.25			650-	
				DUE 10-21-1978						
				2 CALL SEARS POE OCT 30 CBOE	26	.68			136-	
				DUE 10-21-1978						
				3 CALL MEYERHAUSER JAN 30 CBOE	26	1.25			375-	
				DUE 1-20-1979						
				2 CALL GOODYEAR JUL 20 AMEX	26	.12			24-	
				DUE 7-22-1978						
				3 CALL GOODYEAR OCT 20 AMEX	26	.37			111-	
				DUE 10-21-1978						

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EXHIBIT A (continued)

Account Data			Balance Summary		Statement Date/Interest		Earnings Summary		I.F. Summary		
Account No.	I.F. No.	Page	Combined Acc't Opening Bal.	Combined Acc't Closing Bal.	Statement/Interest Period		Dividend YTD		Cash Available	Interest YTD	
					05/01 - 05/26/70						
Social Security/RR No.			Short Acc't Opening Bal.	Short Acc't Closing Bal.	Interest Rate	Interest Charge	Bond Interest YTD		Cash Appraisal Balance	Commission YTD	
CONTINUED											
Investment Expenses Name			Paired Portfolio Value	Buying Power	Average Netty Balance		Municipal Interest YTD		Equity	% Valuation	Last Statement Date

Bought Rec'd or Loan	Sold Held or Short	Description	Type	Price or Entry	Amount Charged	Amount Credited	Commission Abt. Value	Legal Title Name Trust
7P	4	AS OF 04/27/78 CALL PEINZOIL JAN 30 CBOE	26	OPT				
7E	4	EXP 01/20/1979 CALL PEFSICO INC JAN 30 CBOE	26	1 7/8	696.31		.53.66	
		EXP 01/20/1979 SV 5-2-70 REF #1361 OPEN AS OF 04/27/78 TO CXL PREVIOUS SELL						
		PORTFOLIO SUMMARY						
	200	AMERICAN HOSPITAL SUPPLY CORP	26	28.00			5,600	
	400	CITICORP	26	23.37			9,348	
	100	EASTMAN KODAK CO	26	54.12			5,412	
	100	GENERAL MOTORS CORP	26	59.87			5,987	
	500	GOODYEAR TIRE & RUBBER CO	26	17.12			8,560	
	200	HONEYWELL INC	26	55.25			11,050	
	100	INTL BUSINESS MACHINES CORP	26	260.75			26,075	
	400	K MART CORP	26	24.62			9,848	
	400	PEINZOIL CO	26	28.75			11,500	
	400	R C A CORP	26	27.25			10,900	
	200	SEARS ROEBUCK & CO	26	24.37			4,874	
	200	STANDARD OIL CO -INDIANA-	26	50.50			10,100	
	200	TRAVELERS CORP	26	35.12			7,024	
	300	WEYERHAEUSER CO	26	25.50			7,650	
		2 CALL TRAVELERS CP AUG 35 PSE	26	1.81			362-	
		DUE 8-19-1970						
		2 CALL AM HOSP SPLY NOV 30 CBOE	26	1.93			386-	
		DUE 11-18-1970						
		1 CALL EASTMAN KODAK JAN 30 CBOE	26	7.87			787-	

The OCC Prospectus

The Options Clearing Corporation ("OCC") prepares and files a registration statement under the Securities Act of 1933 (the Securities Act) as the "issuer" of all listed options traded on the five options exchanges. This registration statement includes the options prospectus and is filed on Form S-1, the Commission's general registration form, which is used when no other specialized form has been designated by the Commission's rules. The most recent options prospectus contains 56 printed pages providing in considerable detail information about OCC itself and information about listed options, their risks and the mechanics of options trading. Exchange rules require that this prospectus be delivered to every customer at or prior to the time his account is approved for listed options trading. The costs of preparation and distribution of this document have been estimated to exceed \$1,250,000 annually.

Including information about the OCC as an issuer for purposes of the Securities Act as well as information about options trading and mechanics has resulted in a lengthy and complicated prospectus which does not meet the needs of option buyers or sellers who may lack the financial background to understand the current prospectus.

Unlike other registration statements which are designed to give a prospective purchaser of a security sufficient information about the issuer of the securities so that an informed investment decision can be reached, the options prospectus is designed to provide options buyers and sellers with adequate information about options trading and about the listed options market. Information about the issuer, such as the

nature of the issuer's business, its officers and directors, competitors, and its financial statements, are of little concern to the audience at whom the OCC prospectus is directed since no purchaser or seller of listed options is really making an investment in OCC. Counsel for the OCC has commented that:

The most useful disclosure for investors does not involve a description of the issuer and its business, but instead calls for a description of the economic risks and uses of options and the mechanics of buying, writing and exercising options. ... Such disclosure bears no relationship to OCC's role as issuer or clearing corporation, but instead relates to either the basic economic characteristics of options or to the rules and procedures of the various exchanges that provide a market for options. _/

The American Bar Association has urged that options should be exempted from the registration provisions of the Securities Act and has offered the following three reasons in support of their position:

The 1933 Act registration is an inefficient and unnecessarily costly way of educating the public regarding options trading and disclosing the attendant risks and obligations. Second, the imposition of the 1933 Act liabilities on parties involved in issuing and trading standardized options is inappropriate and may adversely affect the quality of public disclosure regarding options. Third, exempting options from the registration provisions of the 1933 Act would clarify the uncertain legal status of the over-the-counter options market and permit equal regulation for standardized listed options and over-the-counter options. _/

_/ Letter dated November 28, 1978 from Schiff Hardin & Waite, Counsel to the OCC, to Richard L. Teberg, at 2.

_/ Letter dated October 24, 1978 from the Subcommittee on Regulation of Securities Options of the Committee on Regulation of Securities, Section of Corporation, Banking and Business Law of the American Bar Association to Richard L. Teberg, at 3-4.

Concern by the OCC with Securities Act statutory liabilities, which normally are imposed upon issuers involved in public offerings of their own securities, has affected the manner in which OCC has drafted the options prospectus. Counsel for OCC has noted that:

because of the strict liabilities under the 1933 Act, the OCC prospectus has had to be drafted in the "defensive" style that is characteristic of the 1933 Act documents, tending to err on the side of too much disclosure, and to include highly technical descriptions and disclaimers covering various remote contingencies. ___/

Procedural requirements under the Securities Act have also resulted in substantial costs in connection with the OCC prospectus. For example, Section 10(a)(3) of the Securities Act prohibits the use of a prospectus more than nine months after the effective date of the registration statement if the prospectus contains information which is more than sixteen months old. The American Bar Association has commented that:

[the requirements of Section 10(a)(3)] when coupled with the requirements of Form S-1 that call for current financial statements to be included in a prospectus, has the effect of requiring a new OCC prospectus to be prepared, filed with the Commission, and distributed to the public on or before October 31 of each year, regardless of whether there have been material changes in the relevant information contained therein. Because of the size of the OCC prospectus (currently 56 pages) and the number of copies

___/ Letter dated November 28, 1978 from the OCC, at 2.

to be distributed (well over 1,500,000 annually), the cost of preparing and distributing a new prospectus is enormous. In addition, because of the threat of civil liability under Section 12(1) of the 1933 Act for failure to deliver a current prospectus (whether or not the changes from a prospectus previously delivered are material), brokers and dealers have been required to establish costly controls to ensure that all customers receive each new prospectus as it becomes available. ___/

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 can and should be separated from information about the OCC. Absent a statutory amendment, the offer and sale of any security, including listed options, must continue to conform to the requirements of the Securities Act. ___/

In order to satisfy the requirements of the Securities Act, and in recognition of the unique kind of "offering" represented by the issuance of listed options, the Options Study has the following recommendations.

___/ Letter dated October 24, 1978 from the ABA, at 5.

___/ The Commission had earlier attempted to reconcile the problem of selling options with the registration requirements of the Securities Act by proposing new Rule 238 under the Securities Act to exempt the offer and sale of certain over-the-counter options from Securities Act registration. A new Rule 9b-2 under the Exchange Act was also proposed at the same time which would have imposed disclosure, suitability, and net capital requirements on brokers and dealers executing customer transactions in options. See Securities Act Release No. 5366 (February 8, 1973) and Securities Exchange Act Release No. 9994 (February 8, 1973). Neither of these proposed rules was adopted.

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. Under Securities Act Rule 153, the OCC prospectus would be available to the public upon request but could be deemed "delivered" to each options customer by the OCC when copies of the OCC prospectus were furnished to the exchanges on which listed options are traded.

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, writing and exercising options; and a simplified discussion of transaction costs, margin requirements and tax consequences of option trading.

This Exchange Act disclosure document could be adopted pursuant to the Commission's broad authority to regulate options trading under Section

9(b) of the Exchange Act. For the reasons cited by the OCC, ___/ the Options Study believes that this Exchange Act disclosure document should not be filed as part of nor incorporated by reference into a Securities Act registration statement filed by the OCC as the technical "issuer" of all listed options.

In view of the potential liability for omissions in a Securities Act prospectus, and in recognition of the fact that the Exchange Act disclosure statement will contain substantial information now included in the OCC prospectus, it would be desirable for the Commission to find, pursuant to its authority under Section 7 of the Securities Act, that certain disclosures concerning options trading which now are included in the OCC prospectus are inappropriate under the new Securities Act registration form developed for the OCC.

Alternatively, as part of the promulgation of a new Exchange Act disclosure document and a more limited Securities Act registration statement, the Commission might set forth certain "safe harbor" provisions which have the effect of relieving OCC and its officers and directors from liability for omission of certain material from the Securities Act registration statement which would be included in the Exchange Act disclosure document. This might be patterned after the recently proposed safe harbor provisions in connection with projections in statements filed under the federal securities laws.

___/ Supra at 3.

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. ___/ Regardless of the statutes under which forms are required or filed, the overriding concern of the Options Study is that potential options traders 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.

___/ Neither alternative, however, would effect the present status of conventional options under the Securities Act, namely, that their offer and sale must be effected in compliance with Section 5.

E. PROMOTING OPTIONS - GENERAL PROBLEMS1. Introduction

In order to establish and maintain an options business, that is, to sell and promote options, a brokerage firm needs to communicate with actual or potential customers. Communication is necessary first to attract the customers to the firm — a practice known in the industry as "prospecting" — and then to keep customers interested in options and in doing business with the firm.

Firms must also communicate with customers for reasons other than to promote business. Before options trading may be considered suitable for a customer, the customer should understand the risks involved in such trading. Since the customer must rely, in large part, on the brokerage firm and its representatives to explain those risks, communications from a brokerage firm may have an educational as well as a promotional purpose. In fact, information supplied to customers by firms generally serves these dual and often competing needs. Finally, a firm must communicate with actual customers to keep them informed of the status of their accounts and of transactions done in their accounts.

At each stage in the communication process, brokerage firms and their registered representatives use a variety of materials and methods to reach customers. Some firms use mass media advertising extensively. Some firms give frequent "seminars". Most firms allow their registered representatives to solicit new business or generate more business through telephone calls.

Promotional materials may also be mailed to "prospects" and existing customers, or may be available at seminars or in brokerage firm offices as "handouts."

The Options Study has reviewed the various types of solicitation and informational materials used by firms to acquire and inform options customers. These materials include advertisements and sales literature, seminar scripts, promotional letters, worksheets and performance reports. The Options Study has also studied a particular sales technique which seems to be unusually effective in enlisting options customers — the "options program."

Although each of these types of materials and solicitation techniques have special problems which will be discussed in following sections, one recurring shortcoming of virtually all types of sales promotional efforts is the underlying message used to attract options customers. The promotional message, conveyed explicitly to the customer by both the brokerage firms and the individual registered representatives, is that predictable and very attractive returns on investment are available, with a minimum of risk, to persons who use options in their investment programs. While this message serves as the most effective means of persuading customers to consider options as an investment, it is frequently misleading.

2. Rates of Return on Investment

A rate of return expresses the relationship between the amount a customer invests and the amount he earns from that investment. For example, if \$100 is earned from a \$1,000 investment in a period of one year, the rate of return is 10 percent per year. Rates of return can be used either to measure the past profitability of an investment, as in a performance report, or to project the profit potential of an investment, as in a worksheet.

When properly used, rates of return may be informative to an investor, but the Options Study believes that options investors generally are misled by the use of rates of return. First, firms and registered representatives tend to overemphasize attractive potential rates of return from options investments while de-emphasizing the risks of options investments. Second, rates of return are often expressed on an annualized basis without any clear discussion or disclosure of the many assumptions which must be made to express the return on an options investment in annualized terms. To compound the problem of the use of rates of return, firms and salespersons sometimes give customers the impression that an attractive percentage return on a recommended options investment or series of investments can be predicted with certainty, thus leading customers to believe that a profit is promised or guaranteed.

a. Exaggerated rates of return

The Options Study has found that attractive rates of return are used in virtually all types of promotional efforts designed to increase investor interest in options, and are used also in materials designed to "educate" customers about options. Typical are the following conclusions in a national brokerage firm's option writing guide:

How much income? How much downside protection?
No assurances can be given. But we believe — based on what has happened over the years — that an option writing program can be expected to produce a yield of about 15% a year on your capital. That's in stable or rising markets. In falling markets, an option writer can possibly acquire protection against a decline of about 15% a year in equity capital.

That isn't yield of course, as in the case of stable or rising markets, but protection. In either case, this percentage figure represents hard cash premiums received at the time of writing an option. Cash that can add to capital or replace capital eroded by declines in stock prices.

On the basis of these statements, several registered representatives have assumed that rates of 15 percent and higher are reasonable returns for options programs and have led customers to expect these kinds of return. Some financial writers have used this national brokerage firm's claim to support their assertions that even greater rates of return are possible from listed options trading. A regional options coordinator in one firm used this statement as the basis for suggesting to registered representatives that they use sales presentations which spoke of an "expected 15% to 20% return."

The options exchanges also have contributed to the overstating of rates of return. For instance, the CBOE has distributed as part of its promotional materials a reprint of an interview in which one of its governors told readers of a widely circulated financial publication:

[A]s a conservative investor, I can write [sell] options to increase my total return from that portfolio of stocks in companies I believe in. People talk about option spreading programs and mention 15%, 20% a year if they're lucky. That's peanuts to what a conservative investor can earn by holding stocks and writing options on them.

Some salespersons have used this interview routinely in order to solicit new options customers.

The results of options trading, however, often are very different from the returns the customer has been led to expect. For example:

- . One investment advisor - registered representative team promised an investor who spoke little English a 1000 percent return on her \$2,000 investment in options over a period of several months. The investor lost her entire investment.
- . Another registered representative told several customers about the 70 percent return he could consistently achieve for clients through an uncovered call writing program. All of these investors suffered substantial losses as the result of this options trading program.
- . Two investors claimed that their registered representatives predicted that they would "double" their money in a short period of time. Both lost substantial parts of their investment.