

Both worksheets and performance reports are generally prepared by individual registered representatives, although, in the case of worksheets, the brokerage firm may supply the format on which the registered representative fills in numbers to illustrate a transaction. If used correctly, both performance reports and worksheets can furnish useful information to existing or potential customers. However, the Options Study has found that as with other promotional materials, worksheets and performance reports too often are used in a manner unfair to investors.

a. Exaggerated returns

Unrealistically high rates of return are often depicted in worksheets. It is not uncommon to see worksheets indicating available returns of up to 30 percent. One registered representative used for sales presentations, and later sent to one of his customers, a worksheet which quoted returns of between 43.1 percent and 73.2 percent. This same worksheet stated:

IF YOU FIND THIS KIND OF RETURN APPEALING TO  
YOU PLEASE CALL ME AND I WILL BE HAPPY TO  
TAKE ALL THE TIME NEEDED TO EXPLAIN. (Emphasis in  
original.)

Still another registered representative used worksheets which showed potential gains of up to 189 percent on proposed options transactions. Given these extraordinary results, the terminology found on one sheet, in which the options writer is called the "banker" (and the purchaser, the "gambler"), seems understated.

Exaggerated return figures are found in worksheets for several reasons. A frequent reason is the omission of certain transactions costs such as commissions and interest costs, which can have significant impact on the profitability of an options transaction.

b. Selective reporting

The Options Study has also found worksheets in which return figures seemed attractive because the presentation showed only the most profitable possible results and omitted disclosure of the less profitable possibilities for the recommended transaction. In contrast, the Options Study did not encounter a single instance in which any anticipated dividend — which would increase the profitability of the transaction — was omitted from an options worksheet computation.

Worksheets also often ignore the possibility of loss which might come about because of a decline in the price of the underlying stock, particularly with respect to covered call writing strategies. For instance, one worksheet form used by registered representatives in several major firms to describe covered writing situations sets forth the following:

PERCENTAGE RETURN ON SELLING OPTIONS

If Stock Is Called

If Stock Is Not Called  
(Assume stock remains at current price)

The two assumptions presented would generally result only in profit to the customer (provided that the sum of the options premium and any stock dividends received is greater than all commission costs incurred). No mention is made of possible declines in stock price, which can result in loss to the customer.

A different kind of selective presentation can distort results when performance reports are used as selling tools as, for example, if only the results of successful accounts are shown to prospective customers while accounts showing losses are not shown.

c. Erroneous calculations

Exaggerated figures may also come about because of errors in calculation. Worksheets and performance reports are usually prepared by individual registered representatives, not by management, and they are error-prone. The Options Study has encountered several situations in which registered representatives prepared either worksheets or performance reports that contained errors. These errors almost always inflated the profitability of a proposed transaction or of a customer's account. For example, the Options Study reviewed one worksheet in which a registered representative computed the customer's commission costs in the proposed transaction as additional income to the customer.

When erroneous or inaccurate return computations are found in a performance report both the customer whose account has been "analyzed"

and prospective customers who are shown the report may be misled. An example of the problems which may arise when performance reports are miscalculated and then used as a sales tool is found in the activities of an options sales team operating in the branch office of a major retail brokerage firm.

Initially, the sales team solicited four customers to participate in a "pilot program" of options investment. After several months of options trading, the accounts of these four "pilot" customers were analyzed for performance by the sales team. One of the registered representatives calculated the following favorable returns on investment for the various types of strategies used in the "pilot program":

(1) Aggressive Call Buying 7 mos. -----	23.59%
(Annualized)-----	40.44%
(2) Aggressive Covered Writing 7 mos. -----	35.06%
(Annualized) -----	60.09%
(3) Conservative Covered Writing 7 mos. -----	22.09%
(Annualized) -----	37.87%

These figures were false. None of the four customers involved in the "pilot program" earned these rates of return. In fact, one of the customers lost \$4,280 during his involvement in the program, and another customer earned only \$3.54 on an \$8,100 investment. The other two participants earned only a 3 percent return on their original investment. In addition, none of these customers participated in the "pilot program" for the full seven months as depicted in the reports.

These incorrect reports were given to the customers involved in the "pilot program" and subsequently were used as promotional materials to solicit new options customers at a series of seminars conducted by the sales team. Many of these new customers were led to believe that they would enjoy comparable returns if they participated in the sales team's new "managed options program."

As a service for certain of these new options customers, the sales team also prepared periodic performance reports which purported to reflect all the transactions that had occurred in each customer's account during the period reported upon, along with the profits and losses incurred as a result of those transactions. All of the reports were inaccurate; they generally inflated the equity value of the customer's account and reflected profits when, in fact, losses had occurred. The following table sets out the reports sent to customers - and the corrected figures:

<u>Customer</u>	<u>Month</u>	<u>Reported Profits (Losses)</u>	<u>Actual Profits (Losses)</u>	<u>Equity Reported to Customer</u>	<u>Customer's Actual Equity</u>
A	June, 1977	\$ 479	(\$ 5,104)	\$10,201	\$ 2,204
B	June, 1977	4,230	( 11,361)	34,730	6,409
C	June, 1977	2,921	( 3,616)	35,203	3,265
D	June, 1977	2,850	( 6,224)	21,185	12,200
E	March, 1977	85	( 450)	9,670	9,935
F	June, 1977	885	( 3,582)	13,985	14,243
G	March, 1977	175	( 1,506)	4,200	2,122
H	June, 1977	3,608	( 1,783)	13,960	6,534
I	June, 1977	964	( 3,438)	No Report	
J	March, 1977	759	( 4,896)	11,900	6,833

d. Deceptive timing

Performance reports, to be useful to a customer, must contain current information since fluctuation in stock or options prices can dramatically alter the results of options trading. Therefore, information which is not current can be as misleading to the options investor as erroneous information. The Options Study encountered some performance reports, however, which included information about a customer's account which was not current. In one instance, a report that was only one week out-of-date told the customer that he "should probably realize . . . \$4,500 as profit for the coming quarter," when, in fact, because of movements in stock prices and transactions after the date of the report, the customer had already lost or was in danger of losing almost all of the \$4,500 "profits" by the time he received the report.

e. Controls(1) Standardized forms

A serious shortcoming with regard to options worksheets is the absence of a standardized format throughout the securities industry and even within firms. Worksheet forms created on an individual basis by registered representatives are more likely to contain arithmetic errors and to have serious disclosure deficiencies than those provided by the brokerage firm. In addition, lack of a standardized format increases the difficulty of analyzing a worksheet for supervisory purposes.

Almost half of the firms in the industry group sample already provide some sort of standard form options worksheet for use by their registered representatives although not all firms require use of the standardized form. Several firms provide worksheets for registered representatives but mark those forms "FOR INTERNAL USE ONLY" or "NOT FOR DISTRIBUTION OUTSIDE OUR FIRM." Making standardized forms available to registered representatives is an insufficient control device, however, if registered representatives, nevertheless, are permitted to use their own options worksheet forms. In one firm which provided standard form worksheets for internal use only, certain registered representatives sent to customers other options worksheets which were never shown to any supervisor of the firm and which gave customers the impression that the options trades described were "no-lose" situations.

A standard form worksheet which provides an organized presentation of all information and disclosures relevant to an options transaction and which is uniform throughout the industry would help both investors and registered representatives understand the precise nature of the options transaction being proposed and, at the same time, provide a basis for prompt audit by the firm or regulators.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD (1) DEVELOP UNIFORM STANDARDIZED OPTIONS WORKSHEET FORMS WHICH REQUIRE DISCLOSURE OF ALL RELEVANT COSTS AND OTHER INFORMATION, INCLUDING AN APPROPRIATE DISCUSSION OF THE RISKS INVOLVED IN PROPOSED TRANSACTIONS; (2) PROHIBIT THE USE OF ANY OPTIONS WORKSHEETS OTHER THAN THE NEW UNIFORM FORMATS AND REQUIRE THAT NEW WORKSHEETS BE FULLY COMPLETED WHENEVER USED.

Performance reports created by registered representatives on an individual basis can likewise be confusing, misleading, incorrect, and difficult to audit. Most firms in the industry group sample rely almost entirely on correspondence reviews to monitor the use of performance reports. However, simple correspondence review procedures are not adequate to deal with the potential problems to customers caused by performance reports. What is called for is detailed financial analysis to evaluate these reports for fairness and accuracy which many supervisors have neither the time nor the expertise to perform. Moreover, many brokerage firms do not provide their sales office supervisors with the information or assistance necessary to accomplish such an analysis on a reasonably prompt basis.

In all of the cases involving misuse of performance reports reviewed by the Options Study, the brokerage firm did not have effective controls to monitor a registered representative's use of performance reports. One solution to the problem of ad hoc performance reports is to produce some form of computerized performance report for

individual customer accounts. Eighteen percent of the industry group sample follow this practice. Even though these computerized reports may be misused by particular registered representatives, they appear to offer some protection to customers by eliminating the erroneous calculations so likely to occur when performance reports are prepared by individual registered representatives. Computerized reports also introduce a degree of standardization which facilitates supervisory review.

(2) Recordkeeping and inspection of worksheets

In order to properly monitor the use of options worksheets, firms must have adequate record retention procedures. Frequently, however, neither options worksheets prepared for "internal use" nor those shown or sent to customers are kept as part of the firm's permanent records. Eighty-seven percent of the industry group sample indicated that they do not require registered representatives to keep copies of options worksheets shown to customers and 65 percent do not specifically require retention of worksheets sent to customers. Even those firms which require retention of worksheets do not always insist that they be kept for an adequate period of time. When options worksheets are retained, they are most commonly kept as part of a branch office's general correspondence file where they are difficult to retrieve and collate with other documents for analysis of trading in an options customer's account.

In view of the problems discovered concerning the use of options worksheets, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD REQUIRE THAT COPIES OF ALL OPTIONS WORKSHEETS WHICH ARE SHOWN OR SENT TO EXISTING OR PROSPECTIVE CUSTOMERS OR WHICH ARE USED AS THE BASIS FOR ANY SALES PRESENTATION TO A CUSTOMER BE RETAINED BY MEMBER FIRMS FOR AN APPROPRIATE TIME IN A SEPARATE FILE IN THE SALES OFFICE IN WHICH THE CUSTOMER HAS AN ACCOUNT.

Record retention procedures can also help control the use of performance reports. Several firms already require that all performance reports be kept permanently but most firms require only that all performance reports be retained for three years or less. Inspections conducted by the Commission's staff indicate, however, that even when performance reports are kept, they are sometimes buried in miscellaneous correspondence files and are, thus, not available for easy and prompt examination in connection with the analysis of a customer's account.

Because the popularity of performance reports can be attributed, in part, to the inadequacies of regular options account statements, implementation of the Options Study's recommendations with respect to improving such statements may make the use of performance reports less attractive to registered representatives. Nonetheless performance reports probably will continue to be used as a sales device. The procedures recommended below may alleviate the problems with performance reports identified by the Options Study.

The Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR RULES TO REQUIRE THAT:

- (1) ALL PERFORMANCE REPORTS SHOWN, GIVEN OR SENT TO CUSTOMERS BY MEMBER FIRMS BE INITIALLED BY THE FIRM'S LOCAL OFFICE SUPERVISOR TO INDICATE A DETERMINATION BY THAT SUPERVISOR THAT THE PERFORMANCE REPORT FAIRLY PRESENTS THE STATUS OF THE ACCOUNT OR THE TRANSACTIONS REPORTED UPON;
- (2) COPIES OF ALL SUCH PERFORMANCE REPORTS SHOWN, GIVEN OR SENT TO CUSTOMERS BE RETAINED BY MEMBER FIRMS IN A SEPARATE FILE AT THE LOCAL SALES OFFICE;
- (3) REGISTERED REPRESENTATIVES BE PROHIBITED FROM SHOWING ANY PERFORMANCE REPORT OF THE OPTIONS ACCOUNT OF ONE CUSTOMER TO OTHER EXISTING OR POTENTIAL CUSTOMERS, UNLESS COMPOSITE FIGURES WHICH FAIRLY PRESENT THE PERFORMANCE OF ALL THAT REGISTERED REPRESENTATIVE'S CUSTOMER OPTIONS ACCOUNTS DURING THE SAME PERIOD ARE ALSO SHOWN.

G. PROMOTING OPTIONS - INVESTMENT PROGRAMS

1. Introduction

A common promotional device used to sell listed options is the "options program," an investment plan employing the systematic use of an options strategy. Programs generally involve a repeating cycle of investments, made for the participating customer by a registered representative pursuant to either a formal or informal grant of discretion from the customer.

Options programs are generally of two types: (1) those sponsored and managed centrally by a brokerage firm or its investment advisory affiliate; and (2) those promoted and managed locally by registered representatives or their affiliated advisers. There are many variations of these two program types.

More than 27 percent of the brokerage firms in the industry group sample offer to their customers "managed options accounts", usually under the central control of an investment manager chosen by the firm. Almost all firms offering such services require that participating customers have substantial net worth and income — and, in some cases, a great deal of sophistication in financial matters. These programs usually employ only covered call writing strategies which are sometimes further limited to the writing of options only against stock which was in the participant's portfolio before he entered the program.

One brokerage firm's description of its centrally managed options program reflects the generally conservative approach of firms toward such programs:

Managed option accounts are offered to customers on a highly selective, individualized basis....[T]rading decisions are made by senior officers of the firm who have long and successful option management histories. This service is only offered to customers who have both the sophistication necessary to evaluate the risks involved and the financial means to absorb loss.

In contrast to the conservative approach and high standards which many firms attempt to maintain for their centrally managed options programs, the same firms often have poor or inadequately enforced standards concerning "programs" run by local options "experts".

## 2. The Attraction of Options Investment Programs

To customers who find options complex and confusing, or who have insufficient time to follow their investments, an options program may appear to be an attractive way to participate in options trading. By joining a program, the participant avoids the frequent and often difficult investment decisions which are necessary in options trading, and instead relies on the judgment of an industry professional who is often touted as an "expert" in options.

To the registered representative and his brokerage firm, options programs offer an obvious attractive opportunity to earn substantial, steady commissions from the repeating investment cycles which characterize such programs. The commission generating opportunities in just one cycle of a simple covered writing program are depicted in Figure I:

FIGURE ICOVERED CALL WRITINGVARIATION ONE - SIX COMMISSIONS

(calls exercised)

<u>Step 1</u>	<u>Step 2</u>	<u>Step 3</u>		<u>Step 4</u>	<u>Step 5</u>
Sell securities presently in account	Purchase optionable securities	Write calls v. securities	CUSTOMER ASSIGNED EXERCISE	Deliver stock	Replace stock; write more calls
(sc)*	(sc)	(oc)**		(sc)	(sc) (oc)

VARIATION TWO - FIVE COMMISSIONS

(calls repurchased before expiration)

<u>Step 1</u>	<u>Step 2</u>	<u>Step 3</u>		<u>Step 4</u>	<u>Step 5</u>
Sell securities presently in account	Purchase optionable securities	Write calls v. securities		Repurchase calls	Write more calls
(sc)	(sc)	(oc)		(oc)	(oc)

VARIATION THREE - FOUR COMMISSIONS

(calls permitted to expire)

<u>Step 1</u>	<u>Step 2</u>	<u>Step 3</u>		<u>Step 4</u>	<u>Step 5</u>
Sell securities presently in account	Purchase optionable securities	Write calls v. securities		Calls expire without exercise	Write more calls
(sc)	(sc)	(oc)		(no commission)	(oc)

\* "sc" = stock commissions

\*\* "oc" = options commissions

In any of these variations, the cycle is repeated for the investor who continues to participate in the program. At each step (except as noted), there is at least one commission charge.

To convince their salespersons to sell listed options, some brokerage firms emphasize how options investment programs can generate substantial commissions. At the behest of his firm, one registered representative told his peers:

My goal this year (my #1 year in production) is \$150,000. I feel I have a fair start at \$75,000 for the first five months. Options have accounted for approximately 50%. Without the concept of a packaged program, I doubt if these figures would be here this soon...

### 3. The Selling of Options Investment Programs

#### a. Sales presentations

The revenue producing qualities of managed options programs cause firms to market such programs heavily. The promotional materials usually stress the use of computers, "mathematical models", statistical analysis, economic models, and other features which highlight the sophistication of the program. The Options Study has found that these "highlights" are sometimes merely a selling device.

Another benefit of managed options programs stressed in promotional materials is the commitment of the registered representative or the firm to monitor closely the customer's account in order to avoid losses. As one registered representative put it:

"I stand ready to assume the total responsibility of monitoring the option positions on a daily basis so that your necessary involvement need be no more time consuming than depositing the checks as they come in."

Many options customers have relied heavily on their registered representatives to monitor their accounts. Unfortunately, this reliance is sometimes misplaced. Particularly where small investors are concerned, registered representatives may find monitoring customer options accounts a nuisance. One national firm, that regularly advertises its willingness to handle small customer accounts, related to its sales force how a successful salesman ("Rick") dealt with this problem -- simply by recommending far-term options series to small customers:

With insignificant option writing accounts (\$10,000-\$15,000) [Rick] suggests that he writes options as far out as possible and therefore has the customer participating, but not necessitating customer review and personal contact. This allows [Rick] to continuously monitor his major accounts and constantly upgrade his clientele through aggressive prospecting. There is no difficulty understanding [Rick's] success.

A salesperson's failure to monitor options accounts can cause customers to experience substantial losses, as the following case illustrates:

A retired couple who previously had owned only municipal bonds and "blue chip" securities was persuaded to entrust \$100,000, more than half of their net worth to a registered representative's uncovered call writing program. The couple claim that they were told that such a program was "conservative" and "absolutely safe". When the couple asked about oversight of their account, they were assured by the registered representative that he "would handle their account as if it belonged to his parents."

After six months of options trading, the registered representative called the retired couple and informed them that their account had lost between \$6,000 and \$8,000 and that he was leaving the firm's employ. The couple then requested that their account be closed and their capital returned to them. They were advised, however, that margin requirements and "pending commitments" of the program made withdrawal of equity unwise. Instead, their registered representative proposed to turn their account over to one of his colleagues who would undertake to close the account.

During the next several months, the couple complained several times about the firm's lack of progress in closing the options account. Each time they were told that more time was needed to unwind the program. In fact, the firm's failure to monitor this account permitted losses to accumulate in excess of \$90,000.

The couple later explained how they came to repose such confidence in their registered representative:

At the beginning [our registered representative] did occasionally keep us generally advised as to his investment direction but he felt that since we were not completely acquainted with options proceedings we should trust his and [the brokerage firm's] judgment since that is what they were being paid to provide.

b. Prepared sales presentations

Some options programs are sold by means of sales presentations prepared by the brokerage firm for registered representatives who themselves may not fully understand the program. These prepackaged sales presentations for options programs are sometimes popularized by area "options co-ordinators" who may maintain a network of "options product leaders" throughout the branch offices of a firm.

In one national brokerage firm, a regional options coordinator prepared the following script for his firm's representatives to use in selling listed options:

(1) With an "established customer":

— "George, you have had a bad five years. Things have not worked out the way we have planned. You have had the risk inherent in the ownership of your stocks during all those years. If you are still willing to accept that risk, and if you are willing to accept a 15-20% annual return on your investments, I would like to discuss a program with you. What I am asking is would you be willing to double your money every four years?"

(2) The "portfolio approach":

— "You have a \$100,000 portfolio. Do you know that I can rent that out for \$80/day, \$560/week? Are you making that kind of return on your money now? [Customer]: 'I want to talk to my accountant, my wife, etc.' [You]: 'How long will that take?' [Customer]: 'Oh, about a month.' [You]: 'If you had an apartment building worth \$100,000 would you leave it unoccupied for a month? I can get you \$2,400 in the next 30 days by renting your portfolio. Let me know.'"

— "Work up two portfolios.... [The] [f]irst should be a conservative one - BS, T, HR, RCA, etc. This one will sell the program to the customer. Should title it 'Suggested Portfolio'.... Set up a second, more aggressive portfolio. Let customer see it but do not emphasize it. You try to sell him the conservative one. Chances are he will opt for the aggressive one."

- "Be sure you have portfolios written up before you make your call. If you say, "I'll call you tomorrow with some ideas", you have lost your impact. Portfolio should consist of 10 stocks. If he doesn't like two, eliminate them. You have just sold eight stocks."

(3) "Converting" a customer into an options writer:

- "When you have him sign the papers, be certain you get the first order with them. Once he has signed the papers and given you the order, he is psychologically ready. You have helped unburden him making an immediate \$100,000 decision and he is thankful for that."
- "Once the RCA is done, call him and tell him you will mail him a check tomorrow for the option premium. It will probably be the first profit he has seen in five years. It will improve his disposition immeasurably."
- "...To earn 15-20% you must create the entire portfolio." This is the standard pitch if the customer does not choose to complete the portfolio. You must let him know that he has assumed the responsibility for any underperformance in the program."

Salespersons are then admonished that, after the customer signs the options papers, they should "get commitments for [regular] referral[s] and [future] addition[s] of capital."

c. Team tactics

Programs run out of local sales offices are frequently formulated and promoted by sales management "teams". These teams may consist solely of registered representatives employed by the firm or may include an investment advisor from outside the brokerage firm. Typically, one or more members of the team are the business getters — soliciting

customers. The other acts as the "money manager" or "options specialist" who will meet the customer, if at all, only during the closing sales presentation when the entire team seeks to impress the customer with its expertise or the sophistication of its "system".

Customers sometimes complain about the high pressure sales tactics employed by some of the teams selling listed options, and, indeed, the Options Study has seen a number of cases in which sales-management teams were engaged in selling practice abuses. Nonetheless, industry literature and internal documents of brokerage firms, encourage the establishment of sales teams to prospect for new business, particularly options business. For example, one regional options coordinator reported to his network of registered representatives in his monthly newsletter:

Which offices are growing the fastest in options and how are they doing it? [Branch A] has organized and formed more teams than the NFL. These groups are selling programs and are starting to build large equity pools. They are concentrating on selling and not on out-smarting the market or overmanaging the equity they have. Watch them over the next few months. (Emphasis in original.)

Of the firms in the industry group sample, 84 percent allow registered representatives to split options commissions, normally an indication that sales-management teams are welcome within the firm.

d. Particular options investment programs

(1) The covered call writing program

Covered call writing programs appear to be the most popular of all options programs.

Sales presentations for covered writing programs frequently emphasize the "income" producing aspects of covered writing. One salesman testified

about the way in which he sold these programs:

...I tried to get the customer to think in terms of checks coming to his house; the dividend checks would come in, the option premium would come in, get him thinking in terms of receiving five checks a year, six checks a year, rather than four. Painting a mental picture of that.

Sales presentations for covered writing programs also emphasize their "conservative" nature. An excerpt from a mailer sent to a random selection of potential customers by a registered representative in a major brokerage firm is typical of the "conservative" approach:

One of the fastest growing segments of the securities business consists of the conservative investment strategy of writing options on common stock. Using this technique, you can expect to substantially increase the current yield on existing or purchased stock positions while at the same time reducing your market risk.

Still other sales presentations focus on the "risk-reduction" features of call writing programs. One prepared sales presentation reviewed by the Options Study has the registered representative telling the potential investor:

We no longer care whether the market is up 10, up 50, down 50. We have transferred this risk of ownership to the option buyer.

What most sales presentations do not stress is the risk of covered writing programs — or covered writing in general. The principal risk is that the underlying stock will decline in value far more than the amount received by the program participant in

premiums on the options he writes. The risk is especially great if the stocks purchased under the programs are volatile.

For example, a customer during 1977 was persuaded by his registered representative to switch his tax free and fixed income securities into a covered writing program. The registered representative had emphasized that such a program was "conservative" but did not explain that the stocks purchased in the program were less "conservative" than the securities already held by the customer. Moreover, the customer misunderstood the meaning of "conservative." He understood a "conservative" program to be one which had income and capital preservation features similar to his previous fixed income securities investment plan. The customer was therefore completely unprepared for the losses which resulted from a decline in the price of the stocks into which he had been switched. In only a few months this investor suffered losses on his newly assumed stock positions in excess of \$7,500, almost twice the options premium "cushion" he had received from writing calls on the stocks.

When the investor complained to the brokerage firm, the firm responded that owning a stock and writing calls against it was more "conservative" than merely owning that same stock. The firm never dealt with the investor's complaint that he would never have purchased such volatile stocks if he had been made aware that the risk of loss was so large.

Although greater risks of loss on the underlying stock are associated with writing covered calls on margin, because of the larger positions taken through borrowing, these additional risks are often not explained to customers. The lack of attention to the risks of trading options on margin is all the more surprising in light of the fact that brokerage firms actively encourage salesmen to open margin accounts for options customers by emphasizing the larger commissions available from margin accounts. In addition, some options strategies can be pursued only in a margin account.

An example of the risks of trading options on margin is found in one discretionary account analyzed by the Options Study.

On June 1, 1977, the investor's account held a large position in one "blue chip" equity security with an aggregate market value of \$855,000. On that date, the investor was convinced by her registered representative to deposit this stock in a newly opened margin account in which covered options were to be written. The borrowing power created was used to finance the purchase of several more volatile stocks against which listed call options were written.

By June 1, 1978 the same investor had experienced the following gains and (losses):

Loss on Stocks - realized	(132,500)
Loss on Stocks - unrealized	(177,900)
Gain on Expired Options	35,700
Dividend Income	10,600
Interest Expense	( 44,400)
Net Loss	<u>(308,500)</u>

These losses represented 36 percent of the investor's initial account equity. Had the investor refrained from margined call writing against volatile stocks and merely held her "blue chip" position, her account would have decreased by \$156,000 or 18 percent. Again, this account received a sales pitch which emphasized the conservative features of a covered call writing program, but was not apprised of the special risks attendant to investing in options on margin.

(2) Exotic and advanced options programs

Some registered representatives and firms offer managed options programs which employ complex trading strategies that even very sophisticated investors cannot always understand. Frequently, the risks of these programs are misrepresented to customers. For example, an uncovered call writing program is generally acknowledged to be a highly risky undertaking. However, the Options Study encountered situations where salespersons claimed that such programs had "capital preservation" features or were "not speculative". Variations of uncovered writing programs (e.g., ratio writing and partly covered warrant-option hedges) have also been sold to investors as though they were simply another form of "conservative" covered writing program.

In addition, the complexities of advanced programs can serve to conceal questionable trading activities by registered representatives and, thus, bear special risks for investors. For example, one middle-aged widow entrusted common stock of twelve blue chip equity issues to her registered

representative's "aggressive" discretionary trading program. The registered representative immediately liquidated the investor's portfolio (generating \$1,600 in stock commissions) and used the proceeds of \$113,000 to establish the following positions for the investor's accounts:

- 7 opening uncovered call sales
- 17 spreads (both vertical spreads and time spreads)
- 15 opening call purchases
- 4 short sales of stock hedged with call purchases (synthetic puts)

Although the investor was told that her accounts were well hedged and diversified as a result of this trading, the hedges dissolved and the initial diversification of the account disappeared within weeks. First, the investor's accounts were assigned fourteen exercise notices, forcing her to buy stock to cover uncovered short call positions and, at the same time, eliminating one side of some spread positions. As a result, the investor's accounts realized trading losses, additional commission costs, and incurred a disproportionate increase in risk. During the same period, some of the account's long call positions which were part of time spreads expired worthless, eliminating one side of several spreads ("leglifting") and leaving the account subject to the greater risks of now uncovered short call options positions. (Time spreads with a short position having a more distant maturity than the long position, are generally considered to be more risky than those in which the long position has a more distant maturity.)