AMERICAN STOCK EXCHANGE, INC.
CHICAGO BOARD OPTIONS EXCHANGE, INC.
MIDWEST STOCK EXCHANGE, INCORPORATED
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
NEW YORK STOCK EXCHANGE, INC.
PACIFIC STOCK EXCHANGE, INCORPORATED
PHILADELPHIA STOCK EXCHANGE, INC.

August 17, 1979

IMPORTANT NOTICE

TO: All Members, Member Organizations and Interested Persons

ATTENTION: Chief Executive Officers or Managing Partners

PROPOSED RULE CHANGES AND INTERPRETATIONS CONCERNING OPTIONS TRADING

Enclosed with this notice are proposed responses to several of the recommendations of the Special Study of the Options Markets. These draft responses have been developed by representatives of the seven self-regulatory organizations issuing this notice, with valuable input coming from many industry sources. These drafts are being circulated for comment as a part of the process looking toward formal filing of proposed rule changes and position papers with the Securities and Exchange Commission. This is the second package of proposals resulting from the Options Study to be submitted for comment. The first such package was circulated on May 16, 1979. That release is discussed later herein.

It should be noted that these proposals have not yet been approved by the governing bodies of any of the self-regulatory organizations.

This notice includes responses to recommendations I.A.2.a. and I.A.2.e. through I.A.2.g., as those recommendations are designated in Securities Exchange Act Release No. 15575, dated February 22, 1979 (the "Release"). The format of the material presented here is (i) the text of the recommendation from the Release, (ii) the proposed response and (iii) a rationale or explanation for each response, headed "Comment."

BACKGROUND

On February 15, 1979, the Securities and Exchange Commission (the "Commission") issued the Report of the Special Study of the Options Markets (the "Report" or the "Options Study"). The Report contained an introduction and seven additional chapters that outlined the results of the Commission's lengthy investigation of standardized options trading. Interspersed throughout the Report were recommendations from the staff of the Options Study that, if adopted, would result in a number of changes in the present scheme of options regulation. Certain of the recommendations called for the self-regulatory organizations ("SROs") to adopt uniform new options rules and to make uniform amendments to existing rules, while others sought modifications in present SRO examination and surveillance procedures.

Following issuance of the Options Study, the Commission issued Release No. 15575, in which the Commission stated its requirements with respect to implementation of the Options Study's recommendations. The Release also provided a timetable for the termination of the moratorium on options expansion that has been in effect since October, 1977. Essentially, the Commission agreed to lift the moratorium if the SROs, individually or collectively, agreed to adopt certain rules and to implement certain procedures within specified periods of time from the date of the Release. The Release states, and the Commission has repeated, that the Commission is prepared to act on its own initiative to implement the recommendations of the Options Study if the self-regulatory organizations fail to do so.

THE SRO TASK FORCE

On March 13, 1979, the chief executive officers of the SROs met with Commission Chairman Harold Williams for the purpose of discussing the Release in detail. Following that meeting, the SROs determined that it would be appropriate to form a joint task force in order to provide, where possible, uniform responses to the Options Study's recommendations. As presently constituted, the Task Force consists of representatives of the American, Midwest, New York, Pacific, and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the National Association of Securities Dealers and one broker-dealer officer appointed as an industry representative by the New York Stock Exchange. The group has held a series of meetings devoting attention primarily to those recommendations that require uniform responses by the SROs.

In drafting these proposals, the Task Force has attempted to design rules that would satisfy the thrust of the Commission's concerns but that would also keep to a minimum the cost, burdens and disruption flowing from the cumulative

effect of implementing the recommendations of the Options Study in their original form. Therefore, the draft rules do not necessarily mirror, word for word, the recommendations in the Release, but do present a reasonable and substantial response to the problems identified by the Options Study, and a response on which the representatives of the seven SROs can all agree.

THE MAY NOTICE

On May 16, 1979, participants in the SRO Task Force issued a joint notice which requested member comment on proposed responses to a substantial number of the Options Study's recommendations. Included in that notice were responses to recommendations I.A.1.a. through I.A.1.p., I.A.2.b. through I.A.2.d. and I.A.3.a. through I.A.3.c. As a result of the comments received, significant changes were made in several of the proposals. Among other things, the amount of background and financial information which members were asked to obtain from their options customers was reduced to include only those items which pertain specifically to customer suitability, inquiries concerning such information were limited to customers who are "natural persons" and the requirement for annual verification of suitability information was eliminated. In addition, the Task Force has now proposed that a member which earned less than $1,000,000 in gross options commissions in either of the two preceding fiscal years or has ten or fewer Registered Options Representatives will be exempt from the requirement to employ a Compliance Registered Options Principal who has no sales function.

At the present time, several of the participants on the Task Force are prepared to file with the Commission rule changes covering the recommendations contained in the May notice; other organizations are still awaiting the necessary approval from their governing bodies before making a filing; and, two SROs, the NASD and the NYSE, have determined to resubmit the proposals to their membership for an additional comment period. As a result, it will not be possible for the SRO Task Force members to make simultaneous filings of uniform rule changes as requested by the SEC. It is anticipated, however, that all Task Force participants will have submitted proposals for Commission approval no later than September 30, 1979.

REQUEST FOR COMMENT

On June 19, 1979, the Task Force presented the proposed rule changes, which are the subject of this notice, together with a position paper which opposed the recommended re-testing of Registered Options Principals and Representatives, to the staff of the Commission for preliminary comment. The Task Force met with the SEC staff on July 12, 1979, to discuss these items. The staff was generally receptive to the proposals and appeared to concur with the Task Force that re-testing would

not be necessary. Most of the comments they offered were in the form of questions concerning the methodology which the Task Force had used in developing the rationale behind its proposal regarding revisions to the customer account statement (I.A.2.a.).

Following the meeting with the Commission staff, Task Force members agreed that the proposals should be circulated for member comment. Even though the group had received considerable industry input during the drafting process, there was a strong desire to confirm that the positions taken were supported by the respective SRO memberships.

The Task Force is particularly interested in receiving comments on its proposal to require that the statements of options customers having a general (margin) account show the mark-to-market price and market value of all positions in the account and the account equity. This is a departure from the original Options Study recommendation which would have required such calculations to be made on all options customer account statements and which would have mandated a profit and loss analysis as well.

As will be seen from our proposed response to I.A.2.a. regarding account statements, the SROs also disagree with the Options Study's recommendation that commissions be set forth on the account statement. Based upon the limited cost data reviewed by the SROs to date, we do not believe that the expenditures necessary to conform with this recommendation are justified in light of the fact, among others, that such information is supplied to customers on confirmations. The Commission staff has indicated interest in exploring further the costs which the Options Study's recommendation on commission disclosure would impose upon member firms. Therefore, it is specifically requested that you address such items as you review this package of proposals, and forward your estimates of such costs along with explanations of the components thereof to the SROs as soon as possible.

In addition, submission to the SROs of your estimates of the entire cost of complying with the SROs proposal for account statement revision as well as the components of such estimates would be greatly appreciated. The SEC staff has requested such data as part of their effort to assess the impact upon the options industry which the SRO's proposed response to the Options Study's recommended account statement revisions may have. We would also appreciate comments on whether the proposed effective date of the rule (i.e., six months following SEC approval) is appropriate.

Members are urged to read this notice carefully and to measure the impact which compliance with the proposed rules would have on their business.

Comments should be directed to any of the undersigned no later than September 14, 1979.

Sincerely,

AMERICAN STOCK EXCHANGE

By _____
Robert J. Birnbaum
President

CHICAGO BOARD OPTIONS EXCHANGE

By _____
Walter E. Auch
Chairman

MIDWEST STOCK EXCHANGE

By _____
Richard B. Walbert
President

NATIONAL ASSOCIATION OF SECURITIES DEALERS

By _____
Gordon S. Macklin
President

NEW YORK STOCK EXCHANGE

By _____
Robert M. Bishop
Senior Vice President

PACIFIC STOCK EXCHANGE

By _____
Philip J. Lo Bue
Senior Vice President

PHILADELPHIA STOCK EXCHANGE

By _____
Elkins Wetherill
President

PROPOSALS* IN RESPONSE TO OPTIONS STUDY RECOMMENDATIONS

(July 31, 1979 DRAFT)

TABLE OF CONTENTS

*NOTE: These proposals have not been approved by the governing bodies of any self-regulatory organization.

Options Study Recommendation 1.A.2.a.

The SROs should adopt rules requiring the account statement of each options customer to show (i) the equity in the customer's account with all options and other securities positions marked to market; (ii) the profit or loss in the account for the year to the date of the statement; and (iii) 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 the year to the date of the statement.

RESPONSE: STATEMENTS OF ACCOUNTS TO CUSTOMERS

Every member organization shall send to its options customers statements of account showing security and money positions, entries, interest charges and any special charges that have been assessed against such account during the period covered by the statement; provided, however, that such charges need not be specifically delineated on the statement if they are otherwise accounted for on the statement and have been itemized on transaction confirmations. With respect to options customers having a general (margin) account, such statement shall also provide the mark-to-market price and market value of each option position and other security position in the general (margin) account, the total market value of all positions in the account, the outstanding debit balance in the account, and the general (margin) account equity. The statement shall bear a legend stating that further information with respect to commissions and other charges related to the execution of listed option transactions has been included in confirmations of such transactions previously furnished to the customer, and that such information will be made available to the customer promptly upon request. The statement shall also bear a legend requesting the customer to promptly advise the member of any material change in the customer's investment objectives or financial situation. Such statements of account shall be sent at least quarterly to all accounts having a money or security position during the preceding quarter and at least monthly to all accounts having an entry during the preceding month.

...Interpretations and Policies

01. For purposes of the foregoing rule, general (margin) account equity shall be computed by subtracting the

total of the "short" security values and any debit balance from the total of the "long" security values and any credit balance.

COMMENT:

For purposes of analyzing and responding to this recommendation, we have restated and rearranged the recommendation in terms of the component parts that we believe the recommendation, as set forth in the Release, would require:

(i) All options and other securities positions, marked-to-the-market, extended and totalled;

(ii) Amount of margin loans outstanding (i.e., the debit balance);

(iii) Equity in the account;

(iv) Profit or loss in the account for the year to date;

(v) Commissions and other transaction-related charges for the period covered by the statement and for the year to date;

(vi) Non-transaction-related charges for the period covered by the statement and for the year to date.

We will comment on each of these elements in turn, explaining how our proposed response meets the recommended item or why we believe it inappropriate to require the account statement to provide a particular item of information. First, however, we believe it necessary to resolve an ambiguity concerning the use of the term "account."

The recommendation speaks in terms of the account of an options customer and the statement with respect to that options account. The ambiguity arises because the word "account" is used in two senses in the securities industry. In the first sense, "account" is used to describe a business relationship. Customer A has an account with XYZ broker; when customer A calls, XYZ broker knows who he is and is willing to place orders on his behalf. In the second sense, "account" is used to mean a particular record of business transactions, and many customers will have more than one such account with their broker, each with a different purpose. Typical accounts that a customer might have with a broker would include a cash account,

an income account, a short account, a general or margin account, a convertible bond account and, perhaps, a special margin account.

We also note at several places in the text of the Report in support of this recommendation (as well as in comments by the SEC Chairman and the staff in relation to the Options Study generally) that these recommendations relate only to options customers and transactions made in connection with options, and they are not intended to be general recommendations that would apply to all securities. In keeping with that intention, our proposed response would require the inclusion of additional information on the account statement with respect to only one of a customer's accounts (in the second sense of that term), but one that would reach the substantial majority of all transactions with respect to listed options (including transactions on underlying securities). We would do this by requiring additional information only with respect to an options customer's general or margin account.*

We believe this limitation is appropriate for a number of reasons. First, by their very nature all complicated options strategies, such as uncovered writing, spreads, straddles and strategies involving compounded positions, must be done in a margin account. Such transactions typically have, as a further complication, the inherent risk of borrowed funds. Only the most basic options transactions (i.e., covered writing and the simple purchase of puts or calls) may be done in a cash account, although we have learned that a number of firms require even these transactions to take place in a margin account. Based upon a small sampling of member firms, we can estimate that at least 70 percent of all options transactions are done in margin accounts. That estimate understates the percentage of public customer options transactions that take place in margin accounts, because the total number of transactions includes those done by institutions (which account for approximately ten percent of the options business and which generally initiate transactions only in a cash account). It seems clear from the findings of the Options Study (pages 81-85 of Chapter V) that the problems of lack of intelligibility of account statements arose in those accounts involving the more complex investment strategies. Thus, improving margin account information recommends itself as the logical solution to solve the perceived problems.

* Existing SRO rules require that each member organization send to its customers on a regular basis certain minimum information with respect to all security and money positions maintained by the firm, as well as entries during the period reported on, and we are preserving those requirements..

Second, limiting the proposed changes to the general or margin account provides a realistic means of limiting the scope of the information required (and the corresponding cost of providing it). By limiting the required additional information to the margin account, the universe of possible securities includes only listed options, listed stocks and OTC margin securities. Information on such securities is readily available and already in use by firms in connection with the margin account, as they must make use of such data in making margin computations.* If other accounts in addition to the margin account were included within the proposed requirements, the universe of possible securities would expand enormously. Not only would all of the foregoing be included, but also preferred stocks, convertible preferreds, convertible bonds, debentures, municipal bonds, government issues, nonmargin OTC stocks, and more. One large firm doing a public customer business has stated that it holds more than 93,000 distinct issues of securities for its customers, for many of which the current prices would be difficult, if not impossible, to obtain. And even if such information were available, it would not be readily usable because of the sheer volume of data. The computing time it would take to go through a list of 93,000 securities would be cost-prohibitive.

Third, limiting the proposed requirements to the general or margin account would provide a natural cut-off for smaller firms that otherwise could be severely impacted by the costs of complying with the requirements. Some of the information required by the recommendation, which may be relatively easy for large firms with sophisticated data processing capabilities to provide to customers, would be almost impossible for a small firm preparing statements manually to provide. Even for firms with substantial computing capability, the costs associated with providing such information will be enormous, as may be seen from the following sampling:**

Firm	Initial Cost ($)	Annual Maintenance ($)
A	400,000	75,000
B	300,000	75,000
C	250,000	200,000
D	200,000	50,000
E	150,000	50,000
F	400,000	100,000
G	400,000	100,000
H	200,000	25,000

* Even as to certain of such securities, firms may only be able to use non-current last sale data, because not all options series trade each day.

** These figures were submitted prior to the time that the SROs formulated this proposed response, and therefore represent costs associated with what the firms understood the Options Study to be requiring, not with what we proposed herein. In each case, however, the firm excluded from its estimated costs any amount associated with providing a "profit and loss" figure.

Although we do not have industry-wide figures, the total estimated initial cost for the eight firms surveyed would be approximately $2,300,000. Extrapolating from that figure to an estimated cost for the more than 700 firms that reported options income during 1978 would result in a figure ranging to tens of millions of dollars. Added to the initial cost would be the annual expense for operating and maintaining such a system. Here too, we would estimate, based upon the survey, that there would be an industry-wide cost of several million dollars annually. Many smaller firms either do not carry margin accounts or give them up to a larger firm. Thus, limiting the proposed additional account statement information to margin accounts would make it possible for such firms to avoid the associated costs and remain competitive, but would still mean that options customers would receive the kind of information that the Options Study has recommended.

We turn now to the component parts of the recommendation. As recommended by the Options Study, we propose to require that the account statement include the mark-to-the-market price and market value for all options and other securities positions, limited as noted above to positions in the general (margin) account. In addition, we are proposing that the total market value for all positions in the margin account (i.e., a sum of the market values of each position) and margin account equity be provided. We have defined General Account Equity in Interpretation .01 to our proposed rule, as the difference between the total of long security values, including any credit balance and the total short security values, including any debit balance. As noted by the Options Study, information with respect to margin loans outstanding (termed "debit balance" in our proposals) is presently required by Rule 10b-16 and is therefore being provided by firms on existing account statements. We would, of course, continue that requirement.

We have not included a requirement that firms include a profit or loss figure on the account statement, because requiring such a figure would present issues of enormous complexity. At the heart of this complexity is the difficulty of establishing and maintaining a valid cost basis over time for each position in each customer's account with a member firm. Among the more obvious elements contributing to this difficulty are securities entered into the account and taken out of the account without the payment of money (such as when an account is transferred from one broker-dealer to another, or when customers deliver securities from safe deposit boxes and other sources), stock splits and stock dividends, realized and unrealized gains and losses, interest and other charges to the account, dividends and interest received, and treatment of premiums received from writing as income or a reduction in the basis of establishing and maintaining the data base are problems stemming from the complexity of the computations involved

for each customer statement and the need to establish uniform principles of accounting for various kinds of transactions.

While it is true that the various entries in an account could be arranged to show what might be called a "profit or loss," it is the universal conclusion of the SRO representatives that any such number would be open to misunderstanding and misinterpretation. Moreover, a "profit and loss" figure is not necessary, because the additional information we are requiring on the account statement, namely the data and method for calculating General Account Equity, does give the customer a useful tool for monitoring his options investments. A comparison of General Account Equity from period to period will give information to the customer as to the status of his account, and it is the availability of such information that appears central to this recommendation of the Options Study.

We are not proposing to require that commissions and other transaction-related charges be included on the account statement. Such information is now fully disclosed on transaction confirmations* and repeating it on the account statement would only be redundant, and therefore unnecessary. The fact that a few, large firms may have such information in a form that might be adapted for inclusion on the customer statement should not, we believe, be the basis for requiring all firms to develop the ability to do so. We are also concerned that providing ever more data on the account statement may ultimately result in the statement becoming less intelligible. We do intend to require that information as to commissions, such as a total for the period covered by the statement or a year-to-date total, be made available on request, and we have included a provision in the proposed rule requiring the account statement to bear a legend to that effect.

We also propose that charges (such as an account transfer fee) that are charged against the account and not itemized on a transaction confirmation be set forth separately on the account statement. We also note, however, that such charges are sometimes separately billed to, and paid by, the customer. We do not propose to require a change in that practice. As in the case of commissions, however, we would expect a firm to furnish such information for the statement period or year-to-date on request of the customer.

PROPOSED EFFECTIVE DATE: Six months following Commission approval

---

* We note that the transaction confirmations now in use by many firms admonish customers to retain such confirmations for tax and other purposes.

Options Study Recommendation I.A.2.e.

> The SROs should adopt rules requiring that the headquarters office of each broker-dealer accepting options transactions by customers be in a position to review each customer's options account on a timely basis to determine (i) commissions as a percentage of the account equity; (ii) realized and unrealized losses in the account as a percentage of the customer's equity; (iii) unusual credit extensions; and (iv) unusual risks or unusual trading patterns in a customer's account.

RESPONSE: SUPERVISION OF ACCOUNTS

Each member organization shall maintain at the principal supervisory office having jurisdiction over the office servicing the customer's account, information to permit review of each customer's options account on a timely basis to determine (i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved; (ii) the size and frequency of options transactions; (iii) commission activity in the account; (iv) profit or loss in the account; (v) undue concentration in any options class or classes, and (vi) compliance with the provisions of Regulation T of the Federal Reserve Board.

COMMENT:

This particular recommendation results from the Study's concerns that member organizations were not monitoring trading in customers' accounts in such a manner as to, among other things, detect trading that was not compatible with customers' investment objectives or uncover churning or other inappropriate trading activity. These are all regulatory problems that for a considerable time prior to the initiation of the Study's review of the options industry the self-regulatory organizations had addressed in various ways. For example, both the COBE* and the American Stock Exchange** published circulars soon after the respective commencement of their options markets, which specified procedures that could be used to assure compliance with those of their rules dealing with the

---

* CBOE Educational Circular #6.

** Regulatory Guidelines for Conducting Public Business in AMEX Options (Puts and Calls).

handling of public customer accounts. In particular, each circular set forth detailed customer account review procedures that, if conducted on a regular basis, would detect and prevent the forms of abuses and irregularities that the Options Study has since focused upon. From a review of the Options Study's findings, it is apparent that the foregoing guidelines for customer account review established by CBOE and Amex have not been adhered to as fully as possible. Consequently, the SROs agree with the SEC's perception that more stringent requirements should be introduced so as to ensure that better quality supervision of customer account activity is fostered among those broker-dealers doing options business with the public.

In formulating our response to this recommendation, we reached a number of conclusions regarding the structure of the recommendation, which are described immediately below. With respect to the portion of the recommendation referring to "headquarters office," we would propose to substitute the phrase "the principal supervisory office having jurisdiction over the office servicing the customers account." As discussed in earlier proposals, e.g., proposed response to recommendation I.A.1.d., this modification reflects the fact that a number of large securities firms have decentralized supervision from the headquarters office to regional supervisory offices.

We have proposed alternatives to the four specific components of the review contained in the recommendation, for a number of reasons. Most important among these reasons is our belief that the components of the recommendation did not provide for the type of account review that would be adequate to deal with the abuses identified within the text of Chapter V of the Options Study. For instance, it was not clear that any of the determinations required to be made by the recommendation would disclose whether the options transactions effected for a customer's account were consistent with the customer's investment objectives and with the types of options strategies for which the customer was approved. Moreover, the language of the recommendation was so vague that the SROs would be unable to precisely instruct members as to their account review responsibilities. For example, requiring member organizations to review accounts for "unusual risks or unusual trading patterns" would be such a broad directive that broker-dealers would be forced to introduce their own subjectivity and interpretation into the compliance process, and thereby preclude uniform application of review procedures.

Because we concur with the concept of improved customer account review, we have taken the opportunity to propose, as specifically as possible, six separate determinations that member firms must be in a position to make with respect to every options customer's account. We believe that application of this proposed response to the SEC's recommendation will

provide the industry with the necessary compliance tools with which to adequately monitor options activity in customer accounts.

In order to provide additional guidance to member organizations, we intend to publish quidelines containing examples of the types of account reviews members may wish to conduct in order to satisfy their obligations under the proposed rule. We anticipate that the guidelines will be contained in a general education circular which will address itself to each of the new options rules developed by the SRO Task Force and approved by the SEC.

Options Study Recommendation I.A.2.f.

> The SROs should adopt rules to require that the training of registered representatives who recommend options transactions to customers be formalized to include a minimum number of hours of approved classroom and on-the-job instruction.

RESPONSE AND COMMENT:

While the SROs agree that there should be increased emphasis on the training of options RRs and of persons seeking to become options RRs, we do not believe that there is any justification for applying to the options field a wholly different approach to training from that which applies to the rest of the securities industry. Certainly no such justification was contained in the few sentences of the Report of the Options Study devoted to this subject. Accordingly, we do not propose to amend the SROs' rules in this respect.

Our objection to the Study's recommendation centers around the fact that it would make the training of RRs unduly formalized and rigid, and would require all persons to undergo the same training regardless of their level of knowledge and experience. Obviously, such a mandatory training program would be inefficient and costly, especially for smaller firms, because the firms would effectively be deprived of the services of their personnel during the time they are involved in the training program.

We believe that a better approach is to permit, and even encourage, flexibility in the development of training programs by SROs and member firms. This is the approach generally

followed in the securities industry, and it has led to the development of a wide variety of effective training techniques, including formal classroom study, training seminars, on-the-job training, correspondence courses, and the like. Indeed, the existing requirements for a minimum period of training and experience included under Amex Rule 341 and NYSE Rule 345 presently cover firms that do approximately 90 percent of the options business.

The SROs are making a number of other changes in response to other requirements of the Options Study that will significantly improve control and supervision of registered personnel. A significant change in this regard will require the assignment of a ROP to almost every branch office. The ROR in the future will be under direct supervision of a ROP and, for that very reason, will have immediately available to him an individual who is experienced and knowledgeable on the subject of options. We also believe that the proposed changes will permit the identification of those instances where improvements in training procedures are called for, without the need for imposing a rigid and costly training program on the entire industry.

Options Study Recommendation I.A.2.g.

> The SROs should establish and maintain a central data file to be available to and used in common by all SROs, containing all customer complaints received directly by the SROs and the disposition of such complaints; the SROs should amend their rules to require their member firms to submit all complaints received from customers and the disposition thereof, to the central data file.

RESPONSE: INTERPRETATION TO RULE REGARDING MAINTENANCE OF BOOKS AND RECORDS

...Interpretation and Policies:

(b) In addition to maintaining a central file of options-related complaints as required by (a) above, every member organization conducting a non-member customer business shall forward a copy of every complaint pertaining to the options activities of the member organization and its associated

persons, within 30 days after receipt, to the designated custodian of the joint self-regulatory organization options complaint registry, and shall also promptly forward advice of any action taken by the member organization in response to such complaints. The options complaint registry is maintained by the National Association of Securities Dealers, Inc. Copies of complaints shall be forwarded to the NASD at 1735 K Street, N.W., Washington, DC 20006. The options complaint registry is a data bank consisting of a record of options-related complaints received by members of the [SRO] and other SROs, and of such complaints received directly by the SROs and the SEC. Information in the options complaint registry will be made available only for bona fide regulatory purposes to national securities exchanges or associations, the SEC or other governmental regulatory agencies.

COMMENT:

Even before the Options Study made its recommendation for the creation of a central repository for customer complaints concerning options, the SROs had given extensive consideration to this subject. Following the issuance of the Report of the Options Study and Release No. 34-15575, the joint SRO Task Force has given further consideration to this matter, and we believe that we have arrived at a solution that permits realization of most of the regulatory benefits identified by the Options Study.

Our proposal calls for the creation of a centralized registry* of customer complaints pertaining to options. Member firms would be required to forward all options complaints to the central registry. The SEC already forwards all customer complaints it receives. The SROs would also, upon approval of this rule, begin to forward complaints received by them.

The central complaint registry will be maintained by the NASD,** which has, since January 1979, operated a pilot program for the centralization of all written customer complaints that it receives as well as those customer complaints

---

* We have used the term "registry" for the joint SRO complaint data bank in order to distinguish it from the central "file" within each firm required by our response to recommendation I.A.1.f.

** The New York Stock Exchange agrees with the centralization of customer complaints, but takes the position that the central registry for each broker-dealer should be lodged with the SRO that is the designated examining authority for the firm under SEC Rule 17d-1. The NYSE also has a functioning data bank of complaints received directly, reported by member firms pursuant to present rules, and forwarded by the SEC in the same mode as sent to the NASD.

that have been submitted to it by the SEC. Under the NASD program, computer-produced reports are generated on a regular basis showing complaint information by type of complaint and type of security involved.

We believe that the central complaint registry would serve most of the regulatory purposes suggested by the Options Study. It would, at a minimum, enhance the ability of SROs to oversee member firms by permitting the early identification of patterns of misconduct involving individual firms and particular locations within a firm. It would also improve routine SRO examinations of member firms by making examiners aware of those areas of the firm's business where special scrutiny is warranted. Finally, the registry would provide these benefits without subjecting the SRO members to duplicate filing requirements.

PROPOSED EFFECTIVE DATE: 30 days following Commission approval.

NOTICE TO MEMBERS: 79-26
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

August 20, 1979

MEMORANDUM

TO: All NASD Members

RE: Questions and Answers Concerning the NASD's Fidelity Bonding Requirements

At its recent meeting, the Advisory Council to the Board of Governors discussed the problems being experienced by members in complying with the Association's fidelity bonding rule (Article III, Section 32 of the Rules of Fair Practice). The Council, which is composed of the incumbent District Committee Chairmen, expressed the opinion that the membership needed more information about the bonding rule, fidelity bonds and how they can be purchased. This Notice to Members has been written in response to the Council's request.

As most members know, the operational stresses upon the securities industry in the late 1960's resulted in the creation of the Securities Investor Protection Corporation (SIPC). SIPC was designed to protect the customers of broker-dealers against certain losses in the event of liquidation. In 1971, SIPC notified the Association that misappropriation of assets was excluded from the risks assumed by the SIPC Fund and requested that the Association consider a fidelity bond requirement for its members. In response, the Board of Governors of the Association formed a Committee on Fidelity Bonding to study the bonding practices of the industry and to make recommendations. The Association's fidelity bonding rule was the result. It became effective on March 15, 1974.

In addition to the NASD, the principal exchanges and the Securities and Exchange Commission have fidelity bonding rules. They have become a permanent feature of the framework of financial regulations under which the securities business operates. The two major problems associated with fidelity bonds are availability and high price. Other problems which

members often have with the rule and about which they frequently ask questions include the following:

- Who must carry a fidelity bond?
- What kind of fidelity bond is required?
- What coverages must be included?
- What is the minimum coverage required?
- Who must be covered under a fidelity bond?
- How are fidelity bonds purchased?
- How much does a bond cost?
- What about alternative methods of supplying coverage?

A brief, but complete, response to each of these questions follows:

- Who must carry a fidelity bond?

The NASD fidelity bonding rule applies to NASD members who are not members of the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange or the Chicago Board Options Exchange. Each of these exchanges has its own fidelity bonding rule. NASD members who are not members of these exchanges, who are required to be members of SIPC and who have employees must carry a bond. Members whose securities business consists exclusively of the sale of mutual funds, variable annuities or insurance, or the providing of investment advice to investment companies or the separate accounts of insurance companies, are exempt from the rule since they are not required to be members of SIPC.

NASD members subject to the rule are required to carry a bond regardless of the nature of the securities business in which they engage, the manner in which they conduct their business, or the amount of time they spend on securities activities.

Members who are introducing firms, who deal only in direct participation programs or who do not habitually handle cash and securities often ask whether they are required to carry a fidelity bond. The answer

is that they are because they are exposed to fidelity risks even though the degree of risk may be less than other firms who operate differently or who are in other facets of the securities business.

- What kind of fidelity bond is required?

The bond required is a standard brokers blanket fidelity bond, known as a Form 14 bond. Occasionally, another number or letter is used, such as Form B, but they all contain similar provisions.

There are many other fidelity bond forms on the market designed for different institutions or industries. Examples are the commercial blanket bond, known as the 3-D bond and the bond forms issued to banks and insurance companies. None of these other forms comply with the NASD rule.

Sometimes fidelity bonds are confused with the surety bonds required by the Blue Sky Laws of many states. Surety bonds differ from fidelity bonds in form, substance and the nature of the insured. They are not a substitute for fidelity bonds. They are generally issued to broker-dealers in amounts ranging up to $25,000 and their major purpose is to protect the public from losses directly caused by violations of state securities laws. Fidelity bonds protect the broker-dealer from catastrophic losses of property due to employee dishonesty and fraud and a variety of other causes except fire. Customers of member firms are not the insureds under fidelity bonds, as they are under surety bonds. Any protection they may receive from fidelity bonds is indirect in the sense that the broker-dealer is protected against the infidelity of its employees and to the extent that this adds to its financial soundness, the public is also protected.

- What coverages must be included?

The coverages required are standard provisions of brokers' blanket bonds. They are listed in the rule and all must be included. They are:

- Loss through employee dishonesty or fraud;
- Loss of property from the premises of the insured firm;
- Loss of property while in transit;
- Loss through forgery of financial instruments such as checks and drafts;

- Loss through forgery of securities or other documents of title; and,

- Loss through fraudulent trading.

In addition, a cancellation rider must be included in which the insurance carrier agrees to use its best efforts to notify the Association in the event that the bond is cancelled or substantially modified.

Sometimes members, perhaps because of the nature of their business, are asked by insurance brokers whether fraudulent trading coverage is to be included. In fidelity bonds, trading is defined as "all transactions involving the purchase, sale or exchange of securities." The term does not have the narrow meaning it usually has in the securities business. Consequently, all members who are subject to the rule must carry fraudulent trading coverage.

A question sometimes asked by members is whether the amount of the bond to be applied for is cumulative. For example, if there are six provisions to be covered for $30,000 each, should the member apply for a bond of $180,000? Coverage is not cumulative. The bond applied for should be for $30,000 face amount.

- What is the minimum coverage required?

The Association's fidelity bonding rule specifies that the bond required must be for an amount at least equal to 120% of the member's minimum required net capital under SEC Rule 15c3-1, with a minimum coverage of $25,000. For example:

Type of Firm	Method of Computing Net Capital	Minimum Net Capital Required 1/	Minimum Coverage Required
Introducing	Standard	$ 5,000	$ 25,000
Self-Clearing	Standard	25,000	30,000
	Alternative	100,000	120,000

1/ For illustration purposes only, this table assumes that, in the case of a firm computing net capital using the standard method, its minimum net capital requirement is greater than 15% of aggregate indebtedness and, in the case of a firm which computes net capital under the alternative method, its minimum net capital requirement is greater than 4% of aggregate debit items computed in accordance with the Reserve Formula to Rule 15c3-3.

Once a year, on the bond anniversary date, members are required to adjust their bond coverage, if necessary, to equal at least 120% of the highest required minimum net capital experienced in the previous 12 months.

Because of high aggregate indebtedness, some members may have to maintain large amounts of net capital. For members who have to maintain net capital in excess of $600,000, the following table indicates the minimum amount of required coverage. It is used in lieu of the 120% ratio.

Net Capital Requirements Under Rule 15c3-1	Minimum Coverage
$ 600,001 - $ 1,000,000	$ 750,000
1,000,001 - 2,000,000	1,000,000
2,000,001 - 3,000,000	1,500,000
3,000,001 - 4,000,000	2,000,000
4,000,001 - 6,000,000	3,000,000
6,000,001 - 12,000,000	4,000,000
12,000,001 and above	5,000,000

A deductible may be included up to the greater of $5,000, or 10% of the required minimum bond. Since bonds provide essentially catastrophic coverage, members should include the highest deductible possible under the rule. This will keep the cost down. Deductibles do not reduce the total coverage; the member self-insures the deductible amount, e.g., bond - $120,000; deductible - $12,000; loss - $132,000. The member would absorb the first $12,000 of the loss and the remaining $120,000 would be paid by the insurance carrier.

The minimum coverages for Fraudulent Trading and Securities Forgery may be less than the basic bond amount. Fraudulent Trading coverage can be not less than 50% and Securities Forgery not less than 25% of the basic coverage with a minimum of $25,000.

- Who must be covered under a fidelity bond?

All employees and officers. In the standard bond, employees are defined as follows:

- officers, clerks and other employees
- officers, clerks and other employees of any predecessor of the member firm acquired by or merged with the member

- guest students pursuing their studies or duties in members' offices

- attorneys and their employees retained by the member while performing legal services for the member

The term "Employee" is generally interpreted by insurance carriers to mean only common law employees, full-time or part-time. Independent contractors are usually excluded from coverage by insurance carriers. Substantial owners of member firms who are actively engaged in the business of a member are usually not covered under the principle that they are the alter ego of their firms and persons cannot insure themselves against losses caused by their own fraudulent or dishonest actions. Consequently, sole proprietors, partners and substantial stockholders are not covered. However, in some bonds, limited coverage is available to partners but only to the extent that losses exceed their interest in the partnership up to the face amount of the bond.

- How are fidelity bonds purchased?

Fidelity bonds are generally sold by independent insurance agents who also sell other lines of casualty insurance. Members normally approach the insurance agent who deals with their other needs for property insurance. However, the market is extremely narrow as very few insurance companies currently offer brokers' blanket bonds. The line has not been profitable and it is relatively small -- about $12 to $13 million of total premiums per year. Further, it is not expanding due to the diminishing number of broker-dealers, loss ratios have been high and losses are extremely volatile from year to year.

Because of the narrow market, some members will on occasion experience difficulty in acquiring and renewing bonds through local insurance agents. This may be because the carriers used by the agent are not currently writing new bonds and he will be forced to try elsewhere. Few carriers are willing to accept applications from agents who have never submitted one before. Sometimes new business will not be accepted from one geographical area although the company is writing business elsewhere. Carriers, who in one year were among the leaders, may restrict new business the next year because of adverse experience.

If the local situation produces no results, members should try a large, national insurance brokerage firm which has its own bonding department and specialists, or a regional firm that specializes in all kinds of bonds.

When attempting to obtain coverage, members should describe exactly what kind of bond they want and the precise amount of coverage and deductible. We have received many calls from insurance agents who do not know exactly what they have been asked to supply. Insurance agents are usually not familiar with the NASD's bonding rule, the SEC's net capital rule or the minimum coverage requirements.

- How much does a bond cost?

The NASD does not have any control over the cost of fidelity bonds. Premium rates are set by the carriers and are subject to State Insurance Department requirements which vary from state to state. Premium levels are directly related to losses and the expenses of underwriting and settling claims, although current rates reflect experience which is about two years old. Some bond premiums have increased as much as 300% in the past few years.

There are some aspects of pricing of which members should be aware. It stands to reason that members who have good loss prevention and security procedures in place and who make the carriers aware of this are likely to pay less than members with poor security procedures. Discounts of as much as 50% are available from manual rates (these are the basic rates which appear in rate manuals of insurance companies). Discounts may also be available for introducing members who never handle cash or securities.

Recently, the Surety Association of America recommended reductions of slightly over 20% in the level of premiums for brokers' blanket bonds. If adopted by individual carriers, the reduction in rates will not be felt uniformly by all broker-dealers. Those with few or no branch offices are likely to feel the effect of the reduction far more than those with many branch offices.

- What about alternative methods of supplying coverage?

Frequently, the problems they are experiencing in the fidelity bonding area have prompted members to suggest that alternative methods of supplying fidelity bonds should be adopted. The NASD's Committee on Fidelity Bonding has spent many hours considering a variety of suggestions ranging from the provision of group insurance to the organization of a fund similar to the SIPC Fund. None of these suggestions have provided practical and attainable answers to the problems.

The problems NASD members are experiencing in the fidelity bonding area are shared by all financial institutions. Studies are currently underway in the banking and securities businesses to explore ways of

alleviating the twin burdens of high cost and lack of availability of fidelity bonding coverage. Some of the alternatives under study include an industry sponsored captive insurance company, association-type programs using a single carrier or a syndicate for primary insurance with excess insurance reinsured, more effective use of current markets by using higher deductibles and industry absorption of some of the services currently being supplied by insurance carriers.

While we do not believe that there are any easy answers to the fidelity bonding problems, we are hopeful that some viable solutions will be found.

* * *

Questions concerning this Notice may be directed to A. John Taylor, Vice President, Variable Contracts Department, NASD, 1735 K Street, N. W., Washington, D. C. 20006, telephone (202) 833-7318.

Sincerely,

Gordon S. Macklin
President

Notice to Members: 79-27
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

August 20, 1979

TO: All NASD Members

RE: Link-Up + 1 Securities, Inc.
3 Park Central, Suite 685
Denver, Colorado 80202

ATTN: Operations Officer, Cashier, Fail-Control Department

On Thursday, August 9, 1979 the United States District Court for the District of Colorado appointed the Securities Investor Protection Corporation as Trustee for Link-Up + 1 Securities, Inc. Previously, the NASD had been appointed Receiver for the firm as reported in NASD Notice to Members 79-19 dated June 4, 1979.

Questions regarding the firm should now be directed to:

Securities Investor Protection Corporation
Attention: Mr. J. H. Moelter
Suite 800, Farragut Building
900 Seventeenth Street, N. W.
Washington, D. C. 20006
Telephone (202) 223-8400

Thomas R. Cassella
Director, Financial Responsibility

NOTICE TO MEMBERS: 79-28
Notices to Members should be retained for future reference.

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

August 21, 1979

TO: All NASD Members and Municipal Securities Bank Dealers
Attention: All Operations Personnel

RE: Holiday Trade Date - Settlement Date Schedule

Securities markets and the NASDAQ System will be closed on Monday, September 3, 1979, in observance of Labor Day. "Regular-Way" transactions made on the business days immediately preceding that day will be subject to the following settlement date schedule.

Trade Date-Settlement Date Schedule
For "Regular-Way" Transactions

Trade Date	Settlement Date	*Regulation T Date
August 27	September 4	September 6
28	5	7
29	6	10
30	7	11
31	10	12
September 3	Labor Day	----
4	11	13

The above settlement dates should be used by brokers, dealers and municipal securities dealers for purposes of clearing and settling transactions pursuant to the Association's Uniform Practice Code and Municipal Securities Rulemaking Board (MSRB) Rule G-12 on Uniform Practice.

Questions regarding this notice may be directed to the Uniform Practice Department at (212) 422-8841.

* * * * *

*Pursuant to Section 4(c)(2) of Regulation T of the Federal Reserve Board, a broker-dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within seven (7) days of the date of purchase. The date upon which members must take such action for the trade dates indicated is shown in the column entitled "Regulation T Date."

NASD

NATIONAL ASSOCIATION OF
SECURITIES DEALERS, INC.

THE New York Stock Exchange

August 31, 1979

M E M O R A N D U M

TO: All Members, Member Organizations and Interested Persons

ATTENTION: Chief Executive Officers or Managing Partners

OPTIONS RULE CHANGE PROPOSALS

Enclosed are proposed responses to a substantial number of the recommendations of the SEC's Special Study of the Options Markets. These draft responses were originally developed by representatives of the seven self-regulatory organizations, including the NASD and NYSE, which constitute the SRO Options Task Force – a group formed in March 1979 to provide, where possible, uniform responses to each of the Options Study's recommendations.

Initial drafts of these proposals were submitted for member comment in a joint SRO notice dated May 16, 1979. As a result of the comments received, significant changes were made in a number of the draft rules. Because of the substantive differences between the current versions of several of the proposals and those which were circulated in May, the National Association of Securities Dealers, Inc., and the New York Stock Exchange have determined that the draft rules should be resubmitted to their respective memberships at this time for additional comment. In order to avoid unnecessary duplication, this mailing will constitute notice from both the NYSE and the NASD.

It should be noted that these rules have not as yet been approved by the Boards of either organization. All comments submitted with regard to this notice will be reviewed before determining whether the proposals should be approved. In this connection, members are urged to examine the draft rules carefully and to measure the impact which compliance with them would have on their business.

The format followed in presenting the proposals herein is (i) the text of the Options Study recommendations; (ii) the draft response, marked to indicate changes from the proposals circulated for comment in May; and, (iii) the rationale or explanation for each response.

All comments to the NASD should be addressed to David P. Parina, Secretary, National Association of Securities Dealers, Inc., and received by the Association by September 30, 1979, in order to receive consideration. Questions regarding this notice should be addressed to S. William Broka, Assistant Director, Department of Regulatory Policy and Procedures, (202) 833-7247.

All comments or questions to the New York Stock Exchange should be addressed to Leo L. McKernan, Assistant Vice President, New York Stock Exchange, Inc., 55 Water Street, New York, New York 10041, (212) 623-4833 and received by the Exchange by September 17, 1979.

Sincerely,

Robert M. Bishop
Senior Vice President
Member Firm Regulation
and Surveillance
New York Stock Exchange, Inc.

Frank J. Wilson
Senior Vice President
Regulatory Policy and
General Counsel
National Association of
Securities Dealers, Inc.

Attachment

PROPOSALS IN RESPONSE TO OPTIONS STUDY RECOMMENDATIONS

(July 31, 1979 DRAFT)*

TABLE OF CONTENTS

*Changes are from the proposals contained in the joint SRO notice, dated May 16, 1979.

New material is indicated by underlining.
Deleted material is indicated by brackets.

Options Study Recommendations I.A.1.a., b. and c.

a. The self-regulatory organizations ("SROs") should amend their options rules (i) to provide a standard options information form which requires that broker-dealers obtain and record sufficient data, as specified by the rules, to support a suitability determination; and (ii) to require firms to adopt procedures to insure that all the information on which account approval is based is properly recorded and reflected in the firm's records.

b. The SROs should amend their options account opening rules to require that (i) the management of each firm send to every options customer for his verification a copy of the form containing the customer's suitability information; and (ii) the source(s) of customer suitability information, including the basis for any estimated figures, be recorded on the customer information forms.

c. The SROs should amend their rules to require that member firms semi-annually confirm the currency of customer suitability information.

RESPONSE: OPENING OF ACCOUNTS

(a) Approval Required. No member organization shall accept an order from a customer to purchase or write an option contract unless the customer's account has been approved for options transactions in accordance with the provisions of this rule.

(b) Diligence in Opening Account. In approving a customer's account for options transactions, a member organization shall exercise due diligence to learn the essential facts as to the customer, his investment objectives and financial situation [and needs], and shall make a record of such information which shall be retained in accordance with Rule ____ (Maintenance of Records). Based upon such information, the branch office manager or other Registered Options Principal shall approve in writing the customer's account for options transactions; provided, [however,] that if the branch office manager is not a Registered Options Principal, his approval shall be confirmed within a reasonable time by a Registered Options Principal.

(c) Verification of Customer Background and Financial Information. The background and financial information upon which [a customer's] the account of every new options customer that is a natural person has been approved for options trading, unless the information is included in the customer's account agreement, shall be sent to [every new options] the customer for verification within fifteen (15) days after the customer's account has been approved for options transactions [and the currency of such information shall be confirmed annually as to all approved options customers]. A copy of the background and financial information on file with the member organization shall also be sent to the customer for verification within fifteen (15) days after the member organization becomes aware of any material change in the customer's financial situation.

(d) Agreements to Be Obtained. Within fifteen (15) days after a customer's account has been approved for options transactions, a member organization shall obtain from the customer a written agreement that the account shall be handled in accordance with the Rules of the SRO and the Rules of the Clearing Corporation and that such customer, acting alone or in concert with others, will not violate the position or exercise limits set forth in Rules ____ and ____.

(e) Prospectus to Be Furnished. At or prior to the time a customer's account is approved for options transactions, a member organization shall furnish the customer with a current Prospectus as defined in Rule ____.

...Interpretations and Policies

.01 In fulfilling its obligations pursuant to paragraph (b) of Rule ____, with respect to options customers who are natural persons, a member organization shall seek to obtain the following information at a minimum (information shall be obtained for all participants in a joint account):

[1. Name of customer -- residence address -- telephone number]

[2.]1. Investment objectives (e.g., safety of principal, income, growth, trading profits, speculation) [amount of funds available for speculative activity]

[3. Place of employment -- address -- business phone -- position -- nature of duties -- length of service]

[4. If self-employed -- address -- business phone -- type of business -- how long engaged]

[5. Date of birth]

2. Employment status (name of employer, self-employed or retired)

3. Estimated annual income from all sources

4. Estimated net worth (exclusive of family residence)

5. Estimated liquid net worth (cash, securities, other)

6. Marital status -- number of dependents [(ages)]

7. Age

[7. Highest level of education achieved]

[8. Is spouse employed -- place of employment -- address and business phone -- position -- nature of duties -- length of service]

[9. Estimated annual income from employment (Husband and Wife)]

[10. Estimated annual income from other sources: real estate -- dividends -- interest -- partnerships -- others]

[11. Does customer rent or own his own home -- equity]

[12. Estimated net worth (exclusive of family residence)]

[13. Estimated liquid net worth (cash, securities, other)]

[14. Insurance]

[15. Bank references -- average balance -- loan experience]

[16. Previous brokerage accounts -- firm -- type of account -- activity]

[17. Does customer currently have an account with firm (how long; type of account; activity)]

[18. Does customer currently maintain account(s) with other firm(s) (name of firm; type of account; activity)]

[19.] 8. Investment experience and knowledge (e.g., number of years, size [and] frequency and types of transactions) for options, stocks and bonds, commodities, other

[20. If joint account, identity of other participants]

In addition, the customer's account records [must] shall contain the following information, if applicable:

a. Source or sources of background and financial information (including estimates) concerning the customer

[b. Nature of transactions for which account is approved (unsolicited; recommended; discretionary)]

[c.] b. Discretionary authorization agreement on file, name, relationship to customer and experience of person holding trading authority

[d.] c. Date prospectus furnished to customer

[e.] d. Type of transaction for which account is approved (e.g., [call] buying, covered [call] writing, [put writing] uncovered writing, spreading)

[f.] e. Name of registered representative

[g.] f. Name of ROP approving account; date of approval

[h.] g. Dates of verification of currency of account information

The member organization should consider utilizing a standard account approval form so as to ensure the receipt of all the required information.

.02 Refusal of a customer to provide any of the information called for in [Items 1 through 20 of] Interpretation .01 shall be so noted on the customer's records [by the member organization personnel opening the account] at the time the account is opened. Information provided shall be considered together with the other information available in determining whether and to what extent to approve the account for options transactions.

.03 The requirement of paragraph (c) of Rule ___ for the initial and subsequent verification of customer background and financial information [may] is to be satisfied by sending to the customer [such

appropriate] the information required in Items 1 through 6 of Interpretation .01 above as [is] contained in the member's records and providing the customer with an opportunity to correct or complete the information. [The annual verification of the currency of customer background and financial information may be accomplished in the same manner as provided for initial verification.] In all cases, absent advice from the customer to the contrary, the information will be deemed to be verified. [Background and financial information with respect to existing options customers must be brought into substantial compliance with the requirements of this rule within two years of its effective date.]

COMMENT:

The first element of recommendation I.A.1.a. calls for a standard options customer information form. In response, we have added a new Interpretation .01 to the "opening of accounts" rules of the SROs that lists the minimum information a member organization must seek to obtain before opening an options account of a customer who is a natural person. The list of information has been reduced to eight (8) items from the twenty (20) which were originally proposed in the May notice. We have not required that all member organizations adopt a uniform options customer information form, since we believe it appropriate that firms should be permitted to develop their own versions of information forms so long as the minimum information required by Interpretation .01 is included.

The second element of the recommendation concerns recordkeeping requirements applicable to options customer information. This would be implemented by including in paragraph (b) of the "opening of accounts" rule a cross-reference to the recordkeeping rule that states how options customer information should be maintained. (See I.A.1.d. below.)

Recommendations I.A.1.b. and c. are dealt with in new paragraph (c) to the "opening of accounts" rule. This paragraph requires that every new options customer who is a natural person be sent for his verification the background and financial information reflected in his customer account information form within 15 days of the approval of his account for options transactions. In addition, this information must be verified within fifteen (15) days after the member becomes aware of any material change in the customer's financial situation by sending to the customer a copy of the background and financial information already on file with the member. In this connection, we would require account statements to bear a legend requesting customers to advise members of any material change in their investment objectives or financial situation. Annual verification of suitability information, originally proposed in the May release, would no longer be mandated.

The rule does not require that a copy of the customer information form itself be sent to the customer (although many firms may choose to do this), because a number of major firms maintain this information in a computerized data bank, and these firms would prefer to send the customer a computer-generated letter containing the information, rather than to have to duplicate many thousands of forms. (See Interpretation .03.)

Options Study Recommendation I.A.1.d.

> The SROs should adopt recordkeeping rules which require that member firms keep copies of account statements, and background and financial information for current customers, and maintain these records both in a readily accessible place at the sales office at which the customer's account is serviced and in a readily accessible headquarters office location.

RESPONSE: INFORMATION OR SUPPLEMENTAL MATERIAL TO RULE CONCERNING MAINTENANCE OF RECORDS

Background and financial information of customers who have been approved for options transactions shall be maintained at both the branch office servicing the customer's account and the principal supervisory office having jurisdiction over that branch office. [Monthly] Copies of account statements of options customers [or other records necessary to the proper supervision of accounts] shall be maintained at [a place easily accessible] both [to] the branch office [servicing] supervising the [customer's] accounts and [to] the principal supervisory office having jurisdiction over that branch [office] for the most recent six-month period. Other records necessary to the proper supervision of accounts shall be maintained at a place easily accessible both to the branch office servicing the customer's account and to the principal supervisory office having jurisdiction over that branch office.

COMMENT:

These records presently must be maintained pursuant to SEC Rule 17a-4 as well as comparable SRO rules. In response to the recommendation that these records be maintained at an easily accessible place at both the branch sales office and at the firm's headquarters,

we propose to add an interpretation to the general recordkeeping rule that would require background and financial information of customers approved for options transactions to be maintained both at the branch office and at the principal supervisory office having jurisdiction over the branch office. In addition, the interpretation would require that monthly account information or other records necessary to the proper supervision of accounts be maintained at both offices for at least the most recent six-month period. We believe that this requirement is fully responsive to the concern of the Options Study that in some cases customer background and financial data and account information has not been available to registered representatives who give advice to their customers. We have not gone so far as to require that all information with respect to a customer be physically located both at the branch and at the headquarters office. We do not believe that the costs of maintaining duplicate sets of records can be justified if the information can in some other way be "easily accessible" to both places. Of course, there is always the possibility the registered representatives will not utilize this information notwithstanding its accessibility, but this problem could just as likely arise if the information were physically located at the sales office. A better answer to the problem of non-utilization of the information is proper supervision, which is being strengthened in response to other recommendations of the Options Study. In place of the reference to "headquarters office," we have substituted the "principal supervisory office having jurisdiction over [the] branch office," reflecting the fact that certain large securities firms have decentralized supervision from the headquarters office to regional supervisory offices.

Options Study Recommendation I.A.1.e.

> The SROs should revise their options customer suitability rules to prohibit a broker-dealer from recommending any opening options transaction to a customer unless the broker-dealer has a reasonable basis for believing 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.

RESPONSE: TO REPLACE SECOND PARAGRAPH OF CURRENT RULES CONCERNING SUITABILITY OF RECOMMENDATIONS

No member, Registered Options Principal or Registered Options Representative shall recommend to a customer an opening

transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the 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 the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract.

COMMENT:

At present, the suitability rules of all SROs contain a general suitability requirement applicable to all recommended options transactions, and also contain more stringent requirements (that the customer be able to evaluate the risks of the transaction and be financially able to bear them) that apply to certain kinds of options writing transactions or recommendations. As the Commission has recommended, our proposal would revise that portion of the SRO suitability rules that contains the more stringent requirements so that a broker-dealer would be prohibited from recommending any opening options transaction to a customer unless these requirements are met.

Options Study Recommendation I.A.1.f.

> The SROs should adopt recordkeeping rules which require member firms which have branch offices to keep copies of customer complaints, customer suitability information and customer account statements at both the branch office where the account is serviced and the headquarters office.

RESPONSE: MAINTENANCE OF BOOKS AND RECORDS

Every member organization conducting a non-member customer business shall maintain and keep current a separate central log, index or other file for all options-related complaints, through which these complaints can easily be identified and retrieved. The central file shall be located at the principal place of business of the member organization or such other principal office as shall be designated by the member organization. At a minimum, the central file shall include: (i) identification of complainant; (ii) date complaint was received; (iii) identification of Registered Representative servicing the account; (iv) a general description of the matter complained of; and, (v) a record

of what action, if any, has been taken by the member organization with respect to the complaint. The term "options-related complaint" shall mean any written statement by a customer or person acting on behalf of a customer alleging a grievance arising out of or in connection with listed options. Each options-related complaint received by a branch office of a member organization shall be forwarded to the office in which the separate, central file is located not later than 30 days after receipt by the branch office. A copy of every options-related complaint shall be maintained at the branch office that is the subject of the complaint.

COMMENT:

This recommendation repeats the recommendation contained in Item I.A.1.d. above, and it makes a new recommendation concerning the need for brokerage firms to maintain copies of customer complaints at branch and headquarters offices. In response to the latter recommendation, we are proposing a new recordkeeping rule that would require member firms to maintain a file of all options-related complaints containing specified information concerning each complaint. The file would be maintained at a single central location. Copies of the complaints themselves would also be forwarded to and maintained at that central location. In addition, a copy of every options-related complaint would be maintained at the branch office that is the subject of the complaint. We have not specified that the central file must be maintained at "headquarters" because this is not a meaningful concept for a number of securities firms. It should be sufficient that the complaints are all recorded in a central place, which will presumably relate to where supervision over the firm's options compliance activities is located.

Options Study Recommendation I.A.1.g.

The rules of the SROs should be amended to require that brokerage firms assign at least one high ranking person who is qualified as a Registered Options Principal ("ROP") to perform, or to directly supervise, home office compliance procedures relating to options. The rules should provide that, absent a clear showing of compelling circumstances, this person have no sales functions, direct or indirect, relating to options or otherwise.

RESPONSE: SUPERVISION OF ACCOUNTS

(a) Senior Registered Options Principal. Every member organization shall designate and specifically identify to the SRO a Senior Registered Options Principal who is an officer (in the case of a corporation) or general partner (in the case of a partnership) of the member organization who shall supervise all of the organization's non-member customer accounts and all orders in such accounts, insofar as such accounts and orders relate to option contracts.

(b) Compliance Registered Options Principal. Member organizations shall designate and specifically identify to the SRO a Compliance Registered Options Principal (CROP) who may be the SROP, who shall have no sales functions and who shall be responsible to review and to propose appropriate action to secure the member organization's compliance with securities laws and regulations and SRO rules in respect of its options business. The CROP shall regularly furnish reports directly to the Compliance officer (if the CROP is not himself the Compliance officer) and to other senior management of the member organization. The requirement that the [Compliance Registered Options Principal] CROP have no sales functions shall not apply [only] to a member organization that has received [more] less than [$100,000] $1,000,000 in gross commissions on options business as reflected in its FOCUS Report for either of the preceding two fiscal years [and has more than 50] or that currently has ten or less Registered Options Representatives [and as to any such member organization, shall not apply if it demonstrates to the SRO compelling reasons why it should not have to comply with this requirement].

COMMENT:

In response to the recommendation that brokerage firms assign a senior ROP with no sales functions to supervise options compliance procedures, we propose to amend the existing "supervision of accounts" rules of the SROs which assign such responsibility to the Senior Registered Options Principal. We propose to add a new paragraph (b) to the rule to require that brokerage firms specifically identify a Compliance Registered Options Principal (CROP) having no sales functions who will be responsible to review the firm's compliance and to propose any appropriate remedial action. Final responsibility for supervision over all of the firm's options activities would, however, remain with the SROP. This separation provides for audit of compliance by someone having no sales functions and yet recognizes that the leadership of most securities firms appropriately has and will continue to have sales functions in combination with supervisory responsibilities. We do, however, propose to have the CROP furnish reports regularly to senior

management of the member. In proposing this amendment, we have attempted to clarify the "compelling circumstances" exception suggested in the Commission's recommendation by providing objective standards relating to the amount of options business done by the firm, so that a firm that did a small amount of options business, and for which the designation of a non-sales CROP would represent a severe economic burden, would not be required to appoint a non-sales person to this position. We propose to include in a future educational circular a fuller description of the CROP's duties.

This proposal has changed significantly from the one contained in the May release. Most notably, the threshold above which a firm must employ a CROP with no sales functions has been increased tenfold - from $100,000 to $1,000,000 in gross options commissions. Further, firms with fewer than ten registered representatives will be exempt from the non-sales CROP requirement.

Options Study Recommendation I.A.1.h.

> The SROs should amend their rules: (i) to require member firms to notify SROs promptly in writing of all internal disciplinary actions against employees, and (ii) to provide that when a registered individual's employment is terminated or he resigns from a member firm, the SRO shall retain jurisdiction over the individual for a reasonable time. The SROs should also vigorously enforce member firm compliance with the notification requirements.

RESPONSE: DISCIPLINARY ACTION BY OTHER ORGANIZATIONS

Every member shall promptly notify the SRO in writing of any disciplinary action, including the basis therefor, taken by any national securities exchange or association, clearing corporation, commodity futures market or government regulatory body against the member or its associated persons, and shall similarly notify the SRO of any disciplinary action taken by the member itself against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of $2,500, or any other significant limitation on activities.

Any member or person associated with a member shall continue to be subject to the disciplinary jurisdiction of the SRO following such person's termination of membership or association with a member with respect to matters that occurred prior to such termination, provided that written notice of the commencement of an inquiry into such matters is given by the SRO to such former member or associated person within one year of receipt by the SRO of written notice of termination of such person's status as a member or person associated with a member.

COMMENT:

We propose the adoption by all SROs of a uniform rule that would be strictly enforced, and would require notification to the SRO of any disciplinary action taken by another SRO or by a government regulator, and would also require notification of internal disciplinary action involving suspension, termination, monetary penalty in excess of $2,500 or imposition of any significant limitation on activities. The exclusion of minor internal disciplinary actions is deemed an essential element of a strict enforcement program, since otherwise SROs and member firms would be burdened with having to process an unmanageable volume of reports of minor infractions. We have also determined that amendments to existing SRO rules are necessary in response to the recommendation for retained jurisdiction over terminated employees in order to provide a uniform industry standard. In response to SEC comments on our original proposals in this area, the rule has been amended to provide that an SRO will retain jurisdiction over a terminated person for a period of one year following receipt of such person's written termination notice.

Options Study Recommendations I.A.1.i., j., k., l. and I.A.3.a., b. and c.

i. The SROs should amend their rules to require (i) that whenever rates of return in options accounts are calculated for disclosure to investors, all relevant costs must be included in the computation; and (ii) that whenever annualized returns are used to express the profitability of an options transaction, all material assumptions in the process of annualizing must be disclosed to the investor and a written record of any rate of return quoted to a customer must be kept.

j. The SROs should (i) 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; and (ii) prohibit the use of any options worksheets other than the new uniform formats and require that all items in the new worksheets be completed whenever used.

k. The SROs 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 with which the customer has an account.

l. The SROs should amend their rules to require that: (i) all performance reports shown, given or sent to customers by member firms be initialed 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; and, (ii) 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.

- - - - - - - -

a. The SROs should take steps, by amending their rules or otherwise, to require that registered representatives be prohibited from showing the 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 shown.

b. The SROs should take steps, by amending their rules or otherwise, to require that member firms make available for public inspection unequivocal and comprehensive evidence to support any claims made on behalf of options "programs" or the options "expertise" of salespersons.

c. The SROs should take steps, by amending their rules or otherwise, to require that when member firms use seminars to promote options, they make the following disclosures to those attending: (i) If the "lecturer" in the seminar is a brokerage firm employee compensated in whole or part by commissions, and is using the seminar technique to attract customers, his financial interest in the acquisition of customers from the audience should be disclosed; (ii) If a "program" or "system" described in the seminar is already in use, the cumulative experience of the program's participants should be fully disclosed and documented, and the audience should be warned that past results are no measure of future performance; and, (iii) If the program is too new to have a performance history, the audience should be fully apprised of the untried nature of the program.

RESPONSE: COMMUNICATIONS TO CUSTOMERS

Rule (a) General Rule. No member or member organization [or person associated with a member] and no partner or employer thereof shall utilize any advertisement, sales literature or other communications to [a] customers or [potential customer] the public concerning options which:

(i) Contains any untrue statement or omission of a material fact or is otherwise false or misleading;

(ii) Contains promises of specific results, exaggerated or unwarranted claims, opinions for which there is no reasonable basis or forecasts of future events which are unwarranted or which are not clearly labeled as forecasts;

(iii) Contains hedge clauses or disclaimers which are are not [easily identifiable] legible, which attempt to disclaim responsibility for the content of such literature or for opinions expressed therein, or which are otherwise inconsistent with such advertisement or sales literature;

(iv) Fails to meet general standards of good taste [judgment] and truthfulness [common to the securities industry]; or,

(v) Would constitute a prospectus as that term is defined in the Securities Act of 1933, unless it meets the requirements of Section 10 of said Act.

(b) Approval by Compliance Registered Options Principal. All advertisements and sales literature (except completed worksheets) issued by a member or member organization pertaining to options shall be approved in advance by the Compliance Registered Options Principal or[, in member organizations not having a Compliance Registered Options Principal, by the Senior Registered Options Principal] his designee. Copies thereof, together with the names of the persons who prepared the material, the names of the persons who approved the material, and, in the case of sales literature, the source of any recommendations contained therein, shall be retained by the member or member organization and be kept at an easily accessible place for examination by the SRO for a period of three years.

(c) SRO Approval Required for Options Advertisements. In addition to the approval required by paragraph (b) of this Rule, every advertisement of a member or member organization pertaining to options shall be submitted to the Department of Sales Practice Compliance of the SRO at least ten days prior to use (or such shorter period as the Department may allow in particular instances) for approval and, if changed or expressly disapproved by the SRO, shall be withheld from circulation until any changes specified by the SRO have been made [and further] or, in the event of disapproval, until the advertisement has been resubmitted for, and has received, SRO approval. The requirements of this paragraph shall not be applicable to:

(i) Advertisements submitted to another self-regulatory organization having comparable standards pertaining to advertisements [pursuant to an arrangement approved by the SRO]; and,

(ii) Advertisements in which the only reference to options is contained in a listing of the services of a member organization.

(d) Except as otherwise provided in the Interpretations and Policies hereunder, no written materials respecting options may be disseminated to any person [without prior or contemporaneous dissemination to such person of] who has not previously or contemporaneously received a current prospectus of the Options Clearing Corporation.

(e) Definitions. For purposes of this Rule, the following definitions shall apply:

(i) The term "advertisement" shall include any sales material that reaches a mass audience through public media such as newspapers, periodicals, magazines, radio, television, telephone recording, motion picture, audio or video device, billboards, signs, or through [letters designed for customer mailing] written communications to customers or the public not required to be accompanied or preceded by a current prospectus of The Options Clearing Corporation.

(ii) The term "sales literature" shall include any written communication [for distribution to customers, potential customers or the public (or which may be shown or made accessible to one or more customers or potential customers or to the public)] (not defined as an "advertisement") distributed or made generally available to customers or the public that contains any analysis, performance report, projection or recommendation with respect to options, underlying securities or market conditions, standard forms of worksheets, or any seminar text which pertains to options and which is communicated to customers[, potential customers] or the public at seminars, lectures or similar such events, or any SRO-produced material pertaining to options.

...Interpretations and Policies

.01 The special risks attendant to options transactions and the complexities of certain options investment strategies shall be reflected in any [advertisement or sales literature] communication which [purports to] discusses the uses or advantages of options. In the preparation of communications respecting options, the following guidelines should be observed:

A. Any statement referring to the potential opportunities or advantages presented by options should be balanced by a statement of the corresponding risks. The risk statement should reflect the same degree of specificity as the statement of opportunities, and broad generalities should be avoided. Thus, a statement such as "with options, an investor has an opportunity to earn profits while limiting his risk of loss," should be balanced by a statement such as "of course, an options investor may lose the entire amount committed to options in a relatively short period of time."

B. It should not be suggested that options are suitable for [most investors, or for small] all investors. [Indeed, it is strongly suggested that there be included in all] All communications [literature] discussing the use of options should include a warning to the effect that options are not for everyone.

C. Statements suggesting the certain availability of a secondary market for options should not be made.

.02 Advertisements pertaining to options shall conform to the following standards:

A. Advertisements may only be used (and copies of the advertisements may be sent to persons who have not received a prospectus of The Options Clearing Corporation) if the material meets the requirements of Rule 134 under the Securities Act of 1933, as that Rule has been interpreted as applying to options. Under Rule 134, advertisements must be limited to general descriptions of the security being offered and of its issuer. Advertisements under this Rule shall state the name and address of the person from whom a current prospectus of The Options Clearing Corporation may be obtained. Such advertisements may have the following characteristics:

(i) The text of the advertisement may contain a brief description of such options, including a statement that the issuer of every such option is The Options Clearing Corporation. The text may also contain a brief description of the general attributes and method of operation of the exchange or exchanges on which such options are traded and of The Options Clearing Corporation, including a discussion of how the price of an option is determined on the trading floor(s) of such exchange(s);

(ii) The advertisement may include any statement required by any state law or administrative authority; and,

(iii) Advertising designs and devices, including borders, scrolls, arrows, pointers, multiple and combined logos and unusual type spaces and lettering as well as attention getting headlines and photographs and other graphics may be used, provided such material is not misleading.

B. The use of recommendations or of past or projected performance figures, including annualized rates of return, is not permitted in any advertisement pertaining to options.

.03 [Sales literature pertaining to options must be preceded or accompanied by a current prospectus of The Options Clearing Corporation and] Written communications (other than advertisements) pertaining to options shall conform to the following standards:

A. Such communications shall state that supporting documentation for any claims (including any claims made on behalf of options programs or the options expertise of sales persons), comparisons, recommendations, statistics or other technical data, will be supplied upon request.

[A]B. [Sales literature and other] Such communications [to customers] may contain projected performance figures (including projected annualized rates of return) provided that:

(i) No suggestion of certainty of future performance is made;

(ii) Parameters relating to such performance figures are clearly established (e.g., to indicate exercise price of option, purchase price of the underlying stock and its market price, option premium, anticipated dividends, etc.);

(iii) All relevant costs, including commissions [material transaction costs] and interest charges (if applicable with regard to margin transactions) are [included and separately identified in all calculations; and such returns are plausible and are intended as a source of reference or a comparative device to be used in the development of a recommendation] disclosed;

(iv) Such projections are plausible and are intended as a source of reference or a comparative device to be used in the development of a recommendation;

[(iv)](v) All material assumptions made in such calculations are clearly identified (e.g., "assume option expires," "assume option unexercised," "assume option exercised," etc.);

[(v)](vi) The risks involved in the proposed transactions are also discussed; and,

[(vi) In the case of an options program (i.e., an investment plan employing the systematic use of an options strategy), the cumulative history or unproven nature of the program is described; and]

(vii) In [the case of literature] communications relating to annualized rates of return, that such returns are not [calculated on any more than four (4) consecutive three-month option periods;] based upon any less than a sixty-day experience; any formulas used in making calculations are clearly displayed; and a statement is included to the effect that the annualized returns cited might be achieved only if the parameters described can be duplicated and that there is no certainty of doing so.

[B]C. [Sales literature] Such communications may feature records and statistics which portray past performance of past recommendation or of actual transactions, provided that:

[(i) Such material includes the date of each initial transaction, the price(s) of such security at that date and at the end of the period when liquidation of the security position(s) was effected and the trend of the market during that period;]

[(ii)](i) Any records or statistics must be confined to a specific "universe" that can be fully isolated and [described] circumscribed and that [is applicable to the customer or customers receiving the material] covers at least the most recent 12-month period;

(ii) Such communications include or offer to provide the date of each initial recommendation or transaction, the price of each such recommendation or transaction as of such date, and the date and price of each recommendation or transaction at the end of the period or when liquidation was suggested or effected, whichever was earlier;

(iii) Such communications disclose all relevant costs, including commissions and interest charges (if applicable with regard to margin transactions) and, whenever annualized rates of return are used, all material assumptions used in the process of annualization;

(iv) In the event such records or statistics are summarized or averaged, such communications include the number of items recommended or transacted, the number that advanced and the number that declined;

(v) An indication is provided of the general market conditions during the period(s) covered, and any comparison made between such records and statistics and the overall market (e.g., comparison to an index) is valid;

[(iii)](vi) A Registered Options Principal determines that the records or statistics fairly present the status of the [accounts] recommendations or transactions reported upon and so initials the report; and,

[(iv)](vii) Such [sales literature shall] communications state that the results presented should not and cannot be viewed as an indicator of future performance.

[C. All sales literature shall state that supporting documentation for any claims (including any claims made on behalf of options programs or the options expertise of sales persons), comparisons, recommendations, statistics or other technical data, will be supplied upon request.]

D. [Sales literature and other communications to customers that portray past performance of actual transactions or that project the potential risks and rewards of proposed transactions shall be kept at a place easily accessible to the sales office for the accounts or customers involved.] In the case of an options program (i.e., an investment plan employing the systematic use of one or more options strategies), the cumulative history or unproven nature of the program and its underlying assumptions shall be disclosed.

E. Standard forms of options worksheets utilized by member organizations, in addition to complying with the requirements applicable to sales literature, must be uniform within a member organization.

F. Communications that portray performance of past recommendations or actual transactions and completed worksheets shall be kept at a place easily accessible to the sales office for the accounts or customers involved.

COMMENT:

The new "Communications to Customers" rule would contain a general statement of principles of truthfulness and good taste applicable to all customer communications (paragraph (a)).

The proposed rule would require approval by the Compliance Registered Options Principal or his designee of all advertisements and sales literature issued by a member or member organization (paragraph (b)) (except for completed worksheets) and would require prior submission to the SRO of every advertisement (paragraph (c)). The proposed rule would require dissemination of an OCC prospectus (paragraph (d)); "advertisement" and "sales literature" would be defined terms (paragraph (e)).

Interpretation .01 under the proposed rule would give more specific disclosure requirements for advertisements and sales literature. Interpretation .02 would set minimum standards and certain other requirements for advertisements. Interpretation .03 would set minimum standards and certain other requirements for other written communications pertaining to options.

Specific Recommendations

I.A.1.i. (Disclosure re: calculation of annual rates of return)

The recommendation requires, whenever rates of return are calculated for disclosure to investors, that all relevant costs be included in the computation and, whenever annualized rates of return are used, that all material assumptions in the process of annualizing must be disclosed and that a written record of any rate of return quoted must be kept.

The proposed rule would prohibit the use of recommendations or of past or projected performance figures, including annualized rates of return, in advertisements. (See Interpretation .02.B.) The standards for the use of projected annualized rates of return in other communications are set forth in Interpretation .03.B., especially subparagraphs (ii), (iii), (iv) and (v). The recordkeeping requirement of the recommendation is satisfied by the general requirement in paragraph (b) that sales literature be kept at an easily accessible place for examination by the SRO for a period of three years and by the more specific requirements of Interpretation .03.F.

I.A.1.j. (Uniform options worksheets)

The recommendation requires the development of uniform standardized options worksheets which disclose all relevant costs and which discuss the risks involved. The recommendation would also prohibit the use of anything other than the uniform format.

We decided to establish uniform minimum standards for option worksheets and in addition, to require that standard worksheets be uniform within a particular firm (e.g., a particular firm would have a single form of covered call writing worksheet for use throughout the firm). The standards for all worksheets are set forth in Interpretation .03.B. and fully satisfy the content requirements of the recommendation. The uniformity requirement is set forth in Interpretation .03.E. Where a firm prepares a standard form of worksheet, that form must be approved by the Compliance Registered Options Principal or his designee, by virtue of the form being included within the definition of "sales literature" (paragraph (e)(ii) of the rule). We are not requiring "uniform standardized worksheets" for use throughout the industry. We understand that different firms view the same strategy in different ways. Because of the difficulty and complexity of developing such worksheets and because it was felt that firms should be free to develop their own marketing efforts, subject only to adequate minimum standards, the proposed rule requires only that standard forms of worksheets be uniform within each firm.

I.A.1.k. (Retention of worksheets)

The recommendation specifies that all options worksheets used as the basis for any sales presentation be retained in a separate file in the sales office in which the customer has an account.

This requirement is satisfied by Interpretation .03.F. The concept of "an easily accessible place" has been used in place of the "in a separate file in the sales office" language of the recommendation. This change supplies the substance of the recommendation, but would also give firms flexibility in how they set up their recordkeeping programs. In addition, the costs of maintaining a separate file in each local sales office could be avoided. (See Comment under I.A.1.d.)

I.A.1.l. (Review and retention of customer performance reports)

The recommendation requires that performance reports shown, given or sent to customers be initialed by the local office supervisor to confirm the accuracy of such reports, and also requires that copies of such reports be maintained in a separate file at the local sales office.

The proposed rule is responsive to the substance of this recommendation. Performance reports are included within the definition of "sales literature" and therefore must be approved by the CROP or his designee. The recordkeeping requirement is supplied by paragraph (b) of the rule and Interpretation .03.F.

I.A.3.a. (Customer performance reports)

The recommendation would prohibit a registered representative from showing a performance report of one customer's options account to any other customer or potential customer unless composite figures showing all that registered representative's accounts are shown.

The proposed rule contains standards for performance reports, i.e., reports which portray past performance of the actual transactions. (See Interpretation .03.C.) The concept of confining reports to a specifically identifiable "universe" (see subparagraph (i) of Interpretation .03.C.) is responsive to the concern behind the recommendation that use of selected results be avoided.

I.A.3.b. (Evidence of claims of performance or expertise)

The recommendation would require member firms to make available for public inspection unequivocal and comprehensive evidence to support claims made on behalf of options programs or the options expertise of salespersons.

The proposed rule contains specific language on this point (see Interpretation .03.A.).

I.A.3.c. (Seminar disclosure)

The recommendation would require that (1) any financial interest of a seminar lecturer in attracting new customers be disclosed, (2) that the cumulative experience of an option program be disclosed, together with a warning that past results are no measure of future performance, and (3) that, if an options program is too new to have a history, the untried nature of the program be described.

The proposed rule would be fully responsive to this recommendation covering these points in the minimum standards for performance reports set forth in Interpretation .03.B. and C.

Options Study Recommendation I.A.1.m.

The SROs should amend their rules to require member firms to adopt promptly a uniform method for the random allocation of exercise notices among their customer accounts.

RESPONSE: ALLOCATION OF EXERCISE NOTICES

Each member organization shall establish fixed procedures for the allocation of exercise notices assigned in respect of a short position in such member organization's customers' account. The allocation shall be made on a "first-in, first-out" basis or [on a] automated random selection basis that has been approved by the SRO or on a manual random selection basis that has been specified by the SRO. Each member organization shall inform its customers in writing of the method it uses to allocate exercise notices to its customers' accounts, explaining its manner of operation and the consequences of that system.

COMMENT:

We have departed somewhat from the Options Study's recommendation that all allocations of exercise notices be made pursuant to a uniform method of random allocation. We agree that all firms that choose in the future to allocate exercise notices randomly on a manual basis should do so in accordance with a uniform method of allocation (essentially in order to simplify the job of auditing the method used to assure that it is, in fact, random). The SROs will adopt a single manual random method of allocation for use by all firms that choose to use such a random method. Those existing automated random methods will be subject to SRO review and approval, although members employing an acceptable automated selection process will not be required to change their programming to adhere to a uniform design. We also do not believe that there is anything inherently unfair or inequitable about FIFO per se, or that there are valid regulatory reasons for precluding the allocation of exercise notices on a FIFO basis, so long as the potential abuses identified by the Options Study are not permitted. Under the proposed rule, any FIFO method used would have to be approved by an SRO, and no such method would be approved unless it was determined to be fair and equitable to customers. In addition, we believe that a firm should inform its customers of the method of allocation it uses, and we have included a requirement to this effect in the rule.

Options Study Recommendation I. A. 1. n.

The SROs should require member firms to keep sufficient specific workpapers and other documentation relating to allocations of exercise notices in proper order of time so that a firm's compliance with the uniform exercise allocation system can be verified promptly for an appropriate period.

RESPONSE: ALLOCATION OF EXERCISE ASSIGNMENT NOTICES

Each member organization shall preserve for a three-year period sufficient workpapers and other documentary materials relating to the allocation of exercise assignment notices to establish the manner in which allocation of such exercise notices is in fact being accomplished.

COMMENT:

We propose adopting a uniform requirement that documentation relating to exercise allocation be preserved for at least three years. This is the retention period prescribed for various documents under SEC Rule 17a-4(b), and should be more than adequate to serve the purpose of auditing compliance with required methods of exercise allocation. Such records would include the record of OCC assignment, a stock record and, in the case of random, a computer-generated or other random number and in the case of FIFO, copies of customer statements showing when positions were established.

Options Study Recommendation I. A. 1. o.

The SROs should adopt rules (i) to require all registered market makers to report to the SROs, promptly and in writing, all accounts, for stock and options trading, in which they have an interest or through which they may engage in trading activities, and (ii) to prohibit trading by market makers through accounts other than those reported.

RESPONSE: REPORTS OF ACCOUNTS

In a manner prescribed by the SRO, each Market Maker shall file with the SRO and keep current a list identifying all accounts for stock, option, and related securities trading in which the Market Maker [has an interest or] may, directly or indirectly, engage in trading activities or over which he exercises investment discretion. No Market Maker shall engage in stock, option, or related securities trading in an account which has not been reported pursuant to this Rule ____.

...Interpretations and Policies

.01 Reports of accounts that need to be filed with the SRO pursuant to this rule relate only to accounts in which a market maker (registered trader/specialist), as an individual, directly or indirectly controls trading activities. Thus, reports would be required for accounts over which a market-maker exercises investment discretion as well as his proprietary accounts. Reports would not be required simply because of a market maker's passive interest in his firm's proprietary accounts. For purposes of this rule, related securities include securities convertible into or exchangeable for underlying securities.

COMMENT:

This proposed rule virtually mirrors the recommendation of the Options Study, except that in addition to requiring that stock and option accounts be reported by market makers, we have included a requirement that accounts in which related securities (e.g., convertibles, warrants, etc.) are carried also be reported. We have also included accounts over which a market maker exercises investment discretion among those required to be reported.

Options Study Recommendation I.A.1.p.

The SROs should adopt rules requiring all registered options market makers to report to the SROs by appropriate means and on a daily basis: (i) the time that each stock order for the market maker's account, or an account in which he has an interest was transmitted for execution;

(ii) the type and terms of each order; (iii) the time reports of any executions were received, and the volume and prices of those executions; and (iv) the opening and closing stock positions for each account in which the market maker has an interest.

RESPONSE: REPORTS OF UNDERLYING SECURITY ORDERS AND POSITIONS

In a manner prescribed by the SRO, each market maker shall, on the business day following order entry date, report to the SRO every order entered by the market maker for the purchase or sale of a security underlying options traded on the SRO or a security convertible into or exchangeable for such underlying security as well as opening and closing positions in all such securities held in each account reported pursuant to Rule (Response to I.A.1.o.). The report pertaining to orders must include the terms of each order, identification of the brokerage firms through which the orders were entered, the times of entry or cancellation, the times reports of executions were received and, if all or part of the order was executed, the quantity and execution price.

COMMENT:

We have proposed a uniform rule that includes all of the elements of the Commission's recommendation, not only with respect to stocks underlying options traded in a particular SRO's market, but also with respect to securities convertible into or exchangeable for such underlying stocks.

Options Study Recommendation I.A.2.b.

The SROs should adopt rules to require that the principal supervisor of any and all offices accepting options transactions be qualified as an ROP.

RESPONSE: REGISTRATION OF OPTIONS PRINCIPALS

No branch office of a member organization shall transact options business with the public unless the principal supervisor of such branch office accepting options transactions has been qualified as a Registered Options Principal; [except] provided that this requirement

shall not apply to branch offices in which not more than three Registered Options Representatives are located, [provided that the member organization can demonstrate that] so long as the options activities of [these] such branch offices are appropriately supervised by a Registered Options Principal.

COMMENT:

We propose adopting a uniform rule requiring that the principal supervisor of every branch office that transacts options business must be qualified as a Registered Options Principal except that, in order to avoid unwarranted burdens on firms having small sub-branch or satellite offices, this requirement will not apply to offices in which not more than three registered options representatives are located. However, even as to those small offices, the firm will have to demonstrate appropriate supervision by a ROP of the options activities of such offices.

Options Study Recommendations I.A.2.c. and d.

> c. The SROs should amend their rules to require that each options customer over whose account discretion is to be exercised shall be provided with a detailed written explanation of the nature and risks of the program and strategies to be employed in his account.
>
> d. The SROs should amend their rules to require that the Senior Registered Options Principal ("SROP") of each brokerage firm personally make a determination that each discretionary customer understands and can bear the financial risks of each options trading program or strategy for which it is proposed that the customer grant investment discretion to the firm or any of its employees; and that the SROP make and maintain a record of the basis for each determination.

RESPONSE: DISCRETIONARY ACCOUNTS

(a) Authorization and Approval Required. No member organization shall exercise any discretionary power with respect to trading in options contracts in a customer's account unless such customer has given prior written authorization and the account has been accepted in

writing by a Registered Options Principal. The Senior Registered Options Principal shall review the acceptance of each discretionary account to determine that the Registered Options Principal accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the strategies or transactions proposed, and he shall maintain a record of the basis for his determination. Each discretionary order shall be approved and initialled on the day entered by the branch office manager or other Registered Options Principal, provided that if the branch office manager is not a Registered Options Principal, his approval shall be confirmed within a reasonable time by a Registered Options Principal. Every discretionary order shall be identified as discretionary on the order at the time of entry. Discretionary accounts shall receive frequent appropriate supervisory review by the Compliance Registered Options Principal.

(b) Options Programs. Where the discretionary account [involves] utilizes options programs involving the systematic use of one or more options strategies, the customer shall be furnished with a written explanation meeting the requirements of Rule ___ (pertaining to sales literature) of the nature and risks of such [strategies] programs.

COMMENT:

Recommendation I.A.2.c. calls for the furnishing of a written description pertaining to "the program and strategies" employed in discretionary accounts. The Report of the Options Study observed that special problems were found where customers "entrusted funds to registered representatives to be managed on a discretionary basis according to the terms of options 'programs' which entailed speculative or risky options strategies." (Ch. V, p. 183) Presumably, the fact that the perceived problems centered on options "programs" was also relevant to the nature of the solution, since the preparation of written explanations is practical insofar as standardized programs are concerned, but would not work for discretionary accounts that are not handled on any systematic basis. For this reason, we have drafted our rule to require a written explanation where the discretionary account utilizes a program involving the "systematic use of one or more options strategies." All such descriptive material would be required to meet the "sales literature" minimum standards of the proposed "Communications to Customers" rule.

We do not believe that it is possible to comply literally with recommendation I.A.2.d., namely, that the SROP of each brokerage firm must make a personal determination that every discretionary customer understands and can bear the risks of the options program or strategies, for a number of reasons: First, if by "personal determination" it is intended that the SROP be in direct contact with every

discretionary customer, this is obviously impossible in a firm of any size. Second, the most that can be required is for the SROP to review the account to determine that the ROP who approved the account had a reasonable basis for believing that the customer had the necessary understanding of and ability to bear the risks. There is no way, short of giving every customer some kind of test, to "determine" that he, in fact, understands the risks of options trading, and even then it would be impossible to make a similar determination as to the customer's ability to bear the risk. Therefore, we are proposing that the SROP review the acceptance of each discretionary account to determine whether the ROP accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the proposed strategies or transactions. Under existing rules, a ROP must personally accept every discretionary account, and the added step of a SROP's review of the ROP's acceptance would seem to provide the kind of supervisory audit that the Options Study found to be missing. As recommended, we propose to require the SROP to make a record of his review.

Proposed Timetable for Effectiveness of Rule Changes

Options Study Recommendation	Number of Days Following SEC Approval
I.A.1.a., b. and c. (Customer Information)	30 days (60 days in the case of subsequent verifications of suitability information)
I.A.1.d. (Customer Records)	90 days
I.A.1.e. (Suitability)	30 days
I.A.1.f. (Customer Complaints)	60 days
I.A.1.g. (Non-Sales Compliance Officer)	90 days
I.A.1.h. (Internal Disciplinary Actions)	30 days (Retention of jurisdiction provision shall, however, take effect immediately)
I.A.1.i. through l.; I.A.3.a. through c. (Communications to Customers)	Immediately (90 days in the case of CROP approval of sales communications)
I.A.1.m. (Allocation of Exercise Notices)	60 days
I.A.1.n. (Allocation Records)	60 days
I.A.1.o. (Reports of Market Maker Accounts)	60 days
I.A.1.p. (Reports of Market Maker Orders)	60 days
I.A.2.b. (Branch Office Supervisor)	90 days
I.A.2.c. and d. (Discretionary Accounts)	60 days (90 days in the case of explanations concerning discretionary trading programs)