

SECTION OF
CORPORATION,
BANKING AND
BUSINESS LAW

EXHIBIT A

AMERICAN BAR ASSOCIATION

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COMMITTEE ON FEDERAL REGULATION OF SECURITIES

October 24, 1978

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Director
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500 N. Capital Street
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SEC. & EXCH. COMM.

Dear Mr. Teberg:

The Securities and Exchange Commission's Special Study of the Options Markets (the "Options Study"), involving as it does a "general review of all aspects of standardized options trading", [1] provides an appropriate occasion for addressing one of the anomalies in the federal securities laws: the application of the Securities Act of 1933, as amended (the "1933 Act"), to options. This letter, which deals with that question, has been prepared by members of the Subcommittee on Regulation of Securities Options of the Committee on Federal Regulation of Securities, Section of Corporation, Banking and Business Law of the American Bar Association with the participation of the other members of the Committee. Drafts of this letter have been circulated among members of the Subcommittee and the chairman of the other Subcommittees of the Federal Regulation of Securities Committee for their comments. However, this letter does not represent the official position of the American Bar Association, the Section, or the Committee. Further, it should be noted that members of the Committee, including persons who participated in drafting this letter, represent clients who may be affected by the matters discussed herein.

For the reasons set forth below, the Committee believes that the report of the Options Study

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should include a recommendation that the 1933 Act be amended to exempt from its registration and related liability provisions options to purchase or sell securities, issued by a person not affiliated with the issuer of the underlying securities. Such an amendment would permit the Commission to regulate the disclosure process with respect to options by exercising its authority under Section 9(b) of the Securities Exchange Act of 1934, as amended (the "1934 Act"), without regard to the formal requirements of the 1933 Act. The result, we believe, would be to improve the quality of public disclosure with respect to options, substantially reduce the cost of such disclosure, relieve persons involved in the issuance and trading of standardized options from inappropriate statutory liabilities, and permit the Commission to eliminate the present disparity in regulation between standardized and "over-the-counter" options. In that connection, we invite your attention to the exemption provisions of §512(i) of the Federal Securities Code (Official Draft).

As an interim measure, until legislation providing such an exemption can be enacted, the Options Study should recommend that the Commission exercise its authority under Section 7 of the 1933 Act to develop a special form for the registration of options that would permit the omission of much of the irrelevant material now required to be included in options registration statements and prospectuses. While this interim step would not achieve all of the benefits of an outright exemption, it would make the options prospectus a more useful and less costly document, and would reduce somewhat the exposure of persons involved in the issuance and trading of options to inappropriate liabilities.

Background

The definition of the term "security" in Section 2(1) of the 1933 Act includes any "investment contract" or "right to . . . purchase" a security, and is therefore broad enough to include options. Despite that fact, there has existed since the enactment of the 1933 Act an over-the-counter

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market in put and call options which are not registered under that Act.[2] The SEC has to date taken no action to require such registration,[3] presumably because of the relatively small size of the market and the fact that the multiplicity of issuers, which makes registration impractical.[4]

In 1973, acting under Section 3(b) of the 1933 Act, the SEC proposed to adopt a new Rule 238 which would have exempted certain over-the-counter options from the 1933 Act registration,[5] together with a new Rule 9b-2 under the 1934 Act which would have imposed disclosure, suitability, and net capital requirements on brokers and dealers executing customer transactions in options.[6] Neither rule was adopted.[7]

When the Chicago Board Options Exchange introduced trading in standardized options in 1973, those options had a common issuer: The Options Clearing Corporation ("OCC").[8] The common issuer made it feasible for standardized options to be registered under the 1933 Act, and they were so registered. Today, all standardized options traded on five national securities exchanges are issued by OCC. They are all registered under the 1933 Act, and a prospectus prepared in accordance with the requirements of Schedule A to the 1933 Act and Form S-1 serves as the medium for public disclosure regarding standardized options.

At present, while the vast majority of option transactions take place in standardized options, there remains a significant market in over-the-counter options (including non-standardized options and so-called "synthetic puts") that are not registered under the 1933 Act. As a practical matter, such options probably cannot be registered because they have no common issuer. It is against that background that the appropriateness of 1933 Act registration for options must be evaluated.

Reasons for Exempting Options

There are three main reasons for exempting options from the registration provisions of the 1933 Act. First, the 1933 Act registration is an inefficient and unnecessarily

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

1. Inappropriateness of the 1933 Act Registration

The registration procedures of the 1933 Act were not designed for options. When applied to over-the-counter options, they cannot as a practical matter be complied with. When applied to standardized options, they impose substantial unnecessary costs on the securities industry and, therefore, on the investing public. Industry sources advise us that they conservatively estimate that the cost of preparation and distribution alone of the 1977-1978 OCC prospectus was approximately \$1,250,000. This estimate excludes very substantial overhead and other costs relating to that prospectus.

One type of costs results from the need to comply with the technical requirements of Schedule A to the 1933 Act and Form S-1. Compliance with those requirements has resulted in the inclusion of substantial amounts of immaterial information in the prospectus for standardized options issued by OCC. The most conspicuous example is the inclusion of full financial statements for OCC, which occupy over nine pages of the prospectus. Such information is of marginal relevance, at best, to purchasers of options, who rely on OCC's "back-up system," as it is characterized in the prospectus, and not on OCC's own earnings or assets, to ensure the performance of OCC's obligations. Other examples of immaterial information include information regarding the management of OCC and the identities and background of its officers and directors, and the extensive discussion of pending litigation. The OCC prospectus could be substantially shortened and simplified if

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immaterial information required by Schedule A to the 1933 Act could be eliminated.

A different type of cost results from the need to comply with the procedural requirements of the 1933 Act. For example, Section 10(a)(3) of that Act prohibits the use of a prospectus more than nine months after the effective date of the registration statement if the prospectus contains information which is more than sixteen months old. That provision, when coupled with the requirements of Form S-1 that call for current financial statements to be included in a prospectus, has the effect of requiring a new OCC prospectus to be prepared, filed with the Commission, and distributed to the public on or before October 31 of each year, regardless of whether there have been material changes in the relevant information contained therein. Because of the size of the OCC prospectus (currently 56 pages) and the number of copies to be distributed (well over 1,500,000 annually), the cost of preparing and distributing a new prospectus is enormous. In addition, because of the threat of civil liability under Section 12(1) of the 1933 Act for failure to deliver a current prospectus (whether or not the changes from a prospectus previously delivered are material), brokers and dealers have been required to establish costly controls to ensure that all customers receive each new prospectus as it becomes available.

Finally, when a material change requiring disclosure does occur, the process of making that disclosure becomes unnecessarily expensive and time-consuming when it has to be made in the context of a 1933 Act registration.

In general, the rigid substantive and procedural requirements of the 1933 Act tend to frustrate the process of devising simpler and less costly ways of making disclosure regarding options. As mentioned above, the Commission could simplify the disclosure process for standardized options to some extent by exercising its authority under Section 7 of the 1933 Act to find certain types of information (e.g. financial statements of the issuer and the identities and background of the issuer's officers and directors) inapplicable to such options and unnecessary for the protection of

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investors. It could simplify that process to a lesser extent by exercising its authority under Section 10(a)(4) of the 1933 Act to permit the omission from the OCC prospectus of some of the information contained in its registration statement.

As interim steps that could be taken pending legislation to provide an exemption from registration, we would support either of these administrative actions. However, they do not fully address the problems of complying with the mechanics of the 1933 Act registration nor do they provide a complete answer to the additional problems of inappropriate liabilities and disparate treatment of over-the-counter options discussed below.

The Commission has plenary authority over the trading of options under Section 9(b) of the 1934 Act. Given that authority, which clearly extends to prescribing the form and content of the disclosures to be made in connection with such trading, it is difficult to see the need to force those disclosures into a format prescribed for wholly different types of securities by the 1933 Act. The 1933 Act is an inappropriate vehicle for disclosure regarding options, and, given the Commission's authority under the 1934 Act, an unnecessary one.

In that connection, we invite your attention to Form S-12 under the 1933 Act which would provide a framework for a new form for the registration of options. The use of the form could be conditioned on there being sent to purchasers of options a document which would describe options in a fashion which would be more meaningful to investors than the 1933 Act prospectus. Since that document would subject the OCC to the less stringent provisions of the 1934 Act, it could avoid the technical verbiage required by the 1933 Act prospectus which we believe detracts from its usefulness as a disclosure document.

2. Inappropriateness of the 1933 Act Liabilities

Sections 11 and 12(1) of the 1933 Act subject issuers

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of securities and their directors, officers, controlling persons and underwriters to severe civil liabilities if the securities are sold by a prospectus containing a material misstatement or omission, or in violation of the registration provisions of the Act. While it is appropriate that persons involved in the issuance and sale of options be subject to antifraud liabilities of the type imposed by Rule 10b-5 under the 1934 Act, the unique characteristics of options, and particularly standardized options, render the special liabilities imposed by Sections 11 and 12(1) of the 1933 Act inappropriate in that context.

Standardized options differ from other types of securities in a number of material respects. First, the issuer derives no benefit from their issuance. The premiums paid by purchasers of standardized options, less transaction costs, are passed on to the writers. The Options Clearing Corporation, the issuer, collects only a small clearing fee (currently 9.5 cents per 100-share option contract). OCC is essentially a service organization, controlled by its clearing members rather than its stockholders.[9] Accordingly, it is not OCC, but rather the securities industry and the investing public, that benefit from the issuance of standardized options. Given the fact that OCC derives no benefit from the options which it issues, and therefore has no incentive to misstate or withhold material facts, it is questionable whether the stringent liabilities of Section 11 of the 1933 Act are appropriate in the context of standardized options.

Options differ from other types of securities in another respect: their value is in large part derivative. The value of an option is significantly affected by the price movements of the underlying security. The issuer of an option and its officers and directors therefore have no special access to the facts which make it a good or a bad investment. They can be expected to be knowledgeable about options generally, but many others in the securities industry can be expected to be equally knowledgeable. The "due diligence" which Section 11 liabilities were designed to promote has less meaning with options than with other securities. For that reason as well, the appropriateness of Section 11 liabilities in the context of options is questionable.

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In practice, the threat of Section 11 liability in the context of options may have the opposite effect from the one intended. Options are "wasting assets," losing all value after a fixed period of time. If an option turns out to have been a bad investment, the investor can lose his entire stake. For that reason, an issuer of options is uniquely exposed to litigation by disappointed investors. When that litigation can take the form of an action under Section 11 of the 1933 Act, not only against the issuer but also against its directors and each officer who signed its registration statement, with the limited defenses available in such actions, there is an inherent incentive to guard against that exposure by the use of lengthy and complex disclosure documents, to the detriment of readability. Relief from the threat of Section 11 liability would encourage the use of less formidable disclosure documents, which would be more useful as tools for the education of investors.

One further difference between standardized options and other securities should be noted. The "distribution" process for standardized options is unique. Standardized options are the subject of a continuous offering. If there are "underwriters" within the meaning of the 1933 Act, they may be the brokers and dealers through whose facilities options are purchased and sold. Unlike underwriters in more typical distributions, they are not parties to an underwriting agreement or otherwise subject to controls imposed by the issuer,[10] nor do they participate in the preparation of the registration statement.

The unique distribution process for standardized options makes the 1933 Act liabilities inappropriate in two additional ways. First given the fact that brokers and dealers have no control over the disclosures made by the issuer of standardized options, it is difficult to justify holding them liable as underwriters under Section 11 should those disclosures prove to be inadequate. Conversely, given the issuer's lack of control over the distribution of disclosure documents to customers, it is hard to justify holding the issuer liable under Section 12(1) if a broker fails to deliver a prospectus.

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In short, the differences between options, and particularly standardized options, and other types of securities, make the liabilities of Sections 11 and 12(1) of the 1933 Act inappropriate in the context of options. Those liabilities stand in the way of improving the quality of public disclosure regarding options; and adequate disclosure can be achieved without them.

3. Over-the-Counter Options

At present, the legal status of over-the-counter options under the 1933 Act is uncertain at best. The 1933 Act requires their registration; yet as a practical matter they cannot be registered. The adoption of proposed Rule 238 would have provided some relief (assuming that the Rule would have been found to be within the SEC's exemptive authority), but it would have left unjustifiable disparities between the disclosures required for standardized options and those required for over-the-counter options, and the liabilities of the persons involved in the issuance and distribution of the respective types of option.

The exemption of options from the registration provisions of the 1933 Act would permit the Commission, acting pursuant to Section 9(b) of the 1934 Act, to prescribe uniform disclosure requirements for all options, without regard to the formal requirements of the 1933 Act, and would leave issuers of standardized and over-the-counter options subject to substantially the same civil liabilities.

Conclusion

The registration provisions of the 1933 Act were not designed for options. The registration of standardized options under the 1933 Act has resulted in substantial unnecessary costs. The direct costs alone of printing and distributing the OCC prospectus, approximately \$1,250,000, are either absorbed by the industry or borne by the investing public in some proportion. To the extent borne by the industry, these costs adversely impact on the industry's financial position with little if any public benefit derived from the expenditure. To the extent that costs to investors are increased, there is little public benefit from the disclosures made because of the unnecessary and complex

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disclosure documents which are created in order to meet the requirements of the 1933 Act. Moreover, registration under the 1933 Act for standardized options creates inappropriate liabilities for parties involved in the issuance and sale of such options and an unjustifiable disparity of regulation between standardized and over-the-counter options.

The Commission has adequate authority to regulate options trading and relating disclosures under Section 9(b) of the 1934 Act. No useful purpose is served by the registration of options under the 1933 Act. The Committee therefore submits that Section 3 of the 1933 Act should be amended to exempt from registration options issued by a person not affiliated with the issuer of the underlying securities.

Until such an amendment to the 1933 Act can be enacted, the Commission should use its administrative authority under Section 7 of that Act to simplify the application of the registration process to options.

Members of the Committee are available to review with members of the staff of the Option Study, the comments and observations made herein.

Respectfully submitted,

Warren F. Grienemberger

Warren F. Grienemberger, Chairman
Federal Regulation of Securities
Committee

Fred N. Gerard

Fred N. Gerard, Chairman
Subcommittee on Regulation of
Securities Options

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NOTES

1. Securities Exchange Act Release No. 14056 (October 17, 1977).
2. Cf. Report on Put and Call Options, Exchange Regulation Section, Division of Trading and Exchanges, Securities and Exchange Commission (August 1, 1961).
3. The Securities and Exchange Commission stated in Securities Act Release No. 5366 (February 8, 1973) that "[t]he Commission recognizes that put or call options have been written and traded for many years without registration under the Act and that the Commission has not promulgated a special form for such registration nor generally taken enforcement action to cause registration."
4. I.L. Loss, Securities Regulation 468 (2d. ed. 1961).
5. Securities Act Release No. 5366 (February 8, 1973).
6. Securities Exchange Act Release No. 9994 (February 8, 1973).
7. The Committee understands that the Commission's failure to adopt Rule 238 was due, at least in part, to a concern that the exemption which would have been created by Rule 238 was beyond the Commission's exemptive authority under Section 3(b) of the 1933 Act.
8. At that time, OCC'S corporate name was "Chicago Board Options Exchange Clearing Corporation."
9. All of OCC's outstanding stock is owned by the five national securities exchanges which currently trade options. However, under its By-Laws, each exchange may designate only one director, and a majority of its directors must be representatives of clearing members, rather than the exchanges.
10. Only those brokers and dealers which are clearing members of OCC are subject to OCC's regulatory jurisdiction. The Committee is advised that as of June 30, 1978, OCC has 143 clearing members.