

MEMORANDUM

January 26, 1979

TO: Chairman Williams

FROM: Division of Market Regulation *AMK*

SUBJECT: Review of the Report of the Special
Study of the Options Markets

As you requested in our meeting on January 11, 1979, several Division staff members (Messrs. Rappaport, Urban, and Carasick, and Mrs. McGrath, our consultant), spent approximately ten days reviewing the entire Options Study Report. 1/ Our initial goal was simply to identify for you any "open manholes" in the Report, that is, any major substantive areas in which we believed the Report was wrong or out of balance as to the facts, the law, policy, or where we had significant disagreements with the Study's conclusions and recommendations.

After we began our review, it became apparent that many of the comments and questions we had concerning the text of the Report itself were problems we probably could resolve with the Study staff. For this reason, we modified, and delayed slightly, our review process to provide an opportunity to discuss, and resolve by mutual agreement with the Study staff, as many problems as possible. At Richard Teberg's suggestion, we coordinated our efforts with Rick Weingarten, and Rick and Marianne Smythe assumed primary responsibility on behalf of the Study for responding to our comments. Where necessary, we worked directly with the Study team leaders responsible for particular chapters and consulted with Richard Teberg by telephone. Revised red-lined copies of the Study Report reflecting the changes made as a result of this process are now being duplicated by the Study staff and will be submitted to the Commission on Monday.

1/ In performing this review, the four-person task force took into consideration notes and comments on the Report previously prepared by other members of the Division staff and briefly consulted those persons on particular chapters. In addition, Lloyd Feller and Mark Fitterman worked with us in reviewing the Market Structure chapter of the Report and Nelson Kibler worked with us in reviewing the Financial Regulation chapter.

At this point, most of our significant comments and questions about the text of the Report itself, which could be resolved without devoting substantial additional time and resources to "restudying" the Study, have been taken care of, and we believe that it should be published as promptly as possible. The Report contains an enormous amount of extremely useful information and numerous recommendations which, if implemented, should result in significant improvements in the regulation of the options markets. We believe it important to begin the process of implementing those recommendations without further delay.

We continue, of course, to have certain reservations about the scope of the Report and the quality and depth of analysis reflected in certain portions of it. Specifically, we believe that the Report does not adequately address, or suggest solutions to, some of the significant issues which were posed by the Commission in public releases announcing the commencement of the Study and the "Options Moratorium." Some of these issues must be dealt with in one form or another in order to unwind the moratorium and process significant rule proposals relating to options in the future. We recognize, of course, that this "shortcoming" is a direct result of the severe time and resource restraints imposed upon the Study, and our comments are not intended in any way to be critical of the performance of the Study staff. Nonetheless, in considering whether to publish the Study Report in its present form, we believe that the Commission should focus upon the limitations in the Report, be aware that the Report does not purport to answer some of the questions which the Commission initially declared had to be answered when the Study was established, and recognize that further data gathering and analysis likely will be required before the Commission will be in a position to act upon some of the specific industry proposals to expand the options markets which will be resubmitted when a program for removing the moratorium is established.

Our specific comments on each Chapter of the Study Report are set forth below:

Chapter I - Introduction.

No "open manholes."

Chapter II - Fundamentals of Exchange Traded Options.

Although we have some reservations about whether this chapter gives the reader a sufficient understanding of the economics of options trading practices discussed in this and later chapters, we believe that, as revised, it contains no "open manholes."

Chapter III - The Use of Options by Professional Traders.

This chapter contains descriptions of certain options trading practices used by professional traders and certain of the trading practice abuses of which the Commission was aware at the time the Study was initiated. Language has been added to the chapter indicating that, due to time and resource constraints, the Study was not able to conduct an independent investigation into all types of trading practices which may be used by professional traders or to evaluate whether such practices present problems requiring regulatory or other action by the Commission. However, because the study was unable to document how manipulations were effected and techniques used to disguise those methods, it was not in a position to recommend remedial, prophylactic rules designed to prevent such practices. The chapter recommends that the Division of Market Regulation continue the work of the Study in the options trading practices area. Other than the limited scope of the chapter reflected in the disclaimer, we believe that it contains no "open manholes."

You should be aware, however, that the Study does not address or resolve the need for, or desirability of, additional puts trading. This is an issue the Commission must resolve before expansion is permitted, since, as you know, there are very few stocks which are not already the subject of call trading which the self-regulatory organizations (SRO's) wish to list.

Chapter IV - SRO Surveillance of Standardized Options Markets.

In our judgment, this Chapter contains no "open manholes." There are, however, several aspects of this chapter which we wish to bring to your attention.

First, the portion of the chapter proposed to be published contains only a very brief summary of the surveillance techniques employed by the various SRO's and does not contain any evaluation of these techniques or draw distinctions between the manner in which the different SRO's apply these techniques. As a result, the chapter may appear

incomplete or inadequate to the reader. This information was deliberately not put in the public portion of the report since the Study staff believed that publicity could impair the effectiveness of the techniques being used. The Division agrees with the Study's decision not to include this material in the public portion of the Report. Detailed descriptions of SRO surveillance techniques and an evaluation of them are, however, contained in the Appendices to this chapter. The Study staff contemplates making these Appendices available to all of the SRO's for their use in implementing improvements to their individual surveillance systems and procedures, and the Commission will be able to use them in evaluating SRO performance.

Second, the chapter contains several recommendations which make it difficult to lift the moratorium and permit expansion by all the existing options exchanges at the same time. These recommendations include:

- (1) The recommendation that the American Stock Exchange, Inc. ("Amex") establish a complete audit trail for options transactions. This recommendation is preceded by a discussion which is severely critical of the Amex's present inability to reconstruct options trading which occurs on its floor for surveillance and enforcement purposes. In light of this finding, it may not be appropriate to permit the Amex to expand its options program until an adequate audit trail is in place. The Division and the Study staff believe, however, that the Amex can complete the efforts it has begun to develop such an audit trail fairly quickly;
- (2) The recommendation that the Philadelphia Stock Exchange ("Phlx") be required to provide complete documentation with respect to the routine surveillance functions and investigations that it performs. Again, it may be necessary for the Commission to obtain this documentation and to satisfy itself that the Phlx is properly carrying out its statutory responsibilities before that exchange is permitted to expand its options trading program. The Division does not know whether the Phlx has the resources to do this promptly enough to be able to begin expanding its options program when the other exchanges are permitted to do so; and
- (3) The recommendation that the Commission conduct a complete inspection of the Midwest Stock Exchange's ("MSE") options surveillance program to determine whether the MSE has the capacity to comply with the law. Again, the Commission may have to resolve this question before the MSE can be permitted to

expand, unless that question first becomes moot as a result of the consummation of the proposed MSE merger with the Chicago Board Options Exchange (a result which, of course, may have other undesirable consequences). We simply do not know whether the MSE has the necessary resources to bring itself into compliance with the law, or whether its expenditure of large sums for this purpose (and the hiring of additional staff) makes sense before the merger question is resolved.

Finally, you should note the recommendation for a thorough Commission inspection of the New York Stock Exchange's ("NYSE") surveillance capabilities. That recommendation and the discussion which precedes it, suggest that the Commission may not be able to consider whether to approve the NYSE's proposal to establish an options program until the Commission is satisfied that the NYSE can fulfill its statutory responsibilities in the market surveillance area.

Chapter V - Options Selling Practices.

This chapter contains extensive recommendations, many of which may be expensive, time consuming and burdensome for the SRO's and their member firms to implement (e.g., the recommendations (i) that the SRO's revise their options examinations and require all options salespersons and all registered options principals to be retested using the new examinations; (ii) that the SRO's require member firms to assign at least one high-ranking "ROP-Qualified" person to supervise the firm's options compliance functions and that, "absent a clear showing of compelling circumstances," this person should have no sales functions; (iii) that SRO suitability rules be tightened, that firms be required semi-annually to update customer suitability information and that firms be prohibited from recommending opening options transactions to persons about whom they do not have sufficient information to make suitability determinations; (iv) that the SRO's require member firms to provide customers substantial additional information on their account statements; and so on).

The recommendations in this chapter generally make sense to the Division and appear likely to effect significant improvements in the regulatory environment governing options selling. Nonetheless, on the basis of the data contained in the Study Report, we are not able to evaluate the impact on the securities industry, particularly small broker-dealers, which the cost of implementing all of these recommendations might have. Nor can we effectively weigh these costs

against the benefits to public investors which will flow from implementation of these recommendations. We think the Commission should consider these cost/benefit factors, as well as possible difficulties which the Commission may encounter overseeing the professional community's implementation of various recommendations, in determining which of the recommendations to insist upon as a precondition to lifting the moratorium. We do not think it necessary, however, to modify these recommendations, or to delete them, from the Study Report.

In addition, we note that the chapter consists largely of a recital of numerous selling practice abuses found by the Study staff. Each of the Study's findings and recommendations is supported by several specific examples of these abuses. It is not possible to determine from the report, however, whether these examples are simply isolated instances of abuse, or whether these practices pervade the securities industry. Moreover, the chapter is not balanced by a discussion of "good" things that the industry may do. For this reason, the chapter may be perceived by some as an unfair attack on the securities industry and may lead to complaints that many of the chapter's recommendations are unnecessary, too burdensome or too expensive. Again, the Division does not think that the Study should be modified in any way to address this potential problem. We think that the disclaimers contained in the introductory chapter and the beginning of the selling practices chapter, noting that the Study did not attempt to provide a balanced evaluation of "good" versus "bad" selling practices, is sufficient to take care of this problem.

Apart from these general concerns, the only unresolved "open manhole" we have identified in this chapter is the Division of Corporation Finance's disagreement with certain portions of the Study's recommendation concerning the Options Clearing Corporation prospectus. We have attached for your convenience a January 19, 1979, memorandum from Dick Rowe, which briefly sets forth his Division's concerns (Exhibit A).

Chapter VI - Self-Regulatory Organization
Oversight of Retail Firms and
Their Associated Persons.

Aside from general concerns about the adequacy of the documentation contained in this chapter to support its conclusions and recommendations, we have identified no "open manholes" in the chapter, as revised.

Chapter VII - Financial Regulation in the Options
Markets.

This chapter contains a number of recommendations for revisions of the Commission's net capital rule. Although most of these recommendations seem to be good ideas, we note that the Report does not contain sufficient data to support the need for several of them, nor does it contain an evaluation of the impact that implementation of these recommendations would have on the securities industry (the recommendations in question appear at pp. 42-43, 47, 49, 50, and 76-77). Since it would not be possible to provide the necessary documentation and analysis at this late date, the Study staff has attempted to alleviate this possible problem by rephrasing these recommendations so that they read "the Commission should consider . . ." rather than, as previously, "the Commission should do. . ." This language change does not cure the problem; it simply adds a little "rubber" to the recommendations and may make it easier for the Commission to decline to adopt some or all of these recommendations if it finds that they are unnecessary or inappropriate.

The last recommendation in the chapter presents greater difficulties. That recommendation (at p. 79 of the Report) is that the SRO's revise their rules to restrict the ability of options market makers to obtain exempt credit, to stock underlying no more than 20 options classes, without specific exchange approval. This recommendation also lacks supporting documentation and analysis, and the figure of "20 options classes" appears to have been selected principally because it would fit current options market maker practices with respect to stock holdings. Implementation of the recommendation probably would, however, effect an improvement over present circumstances, since options market makers now are permitted to use exempt credit to finance transactions in stocks underlying all options classes traded on the floor of their exchange, regardless of whether they in fact are making markets in all of those options classes. A fundamental problem with this particular recommendation, and the discussion in the chapter which precedes it, is that it assumes that options market makers should be entitled to use exempt credit to finance so-called "hedging" transactions in the

stocks underlying at least some of the options classes which they trade. The Study does not, however, attempt to define or evaluate the nature and extent of the market making functions that these persons perform in the multiple market maker environment of the options exchanges, or how and to what extent they contribute to the depth, continuity or liquidity of the options markets, and in which option classes. The Report also does not address the question whether the contribution to the options markets made by these persons justifies the use of exempt credit for transactions in stocks underlying the options they trade at all or, if it is justified, to what extent and in which stocks. Nor does the Report evaluate whether the use of exempt stock credit by options market makers to "hedge" options positions is justified by the market-making functions they perform, or discuss whether, and to what extent, that type of "hedging" ability is needed when standardized puts are listed and traded. The difficulties in defining "hedging" in any way, much less in a continuing way, were explored earlier this week in the context of the Commission's interpretation of Section 11(a) of the Securities Exchange Act.

Apart from the foregoing, we have identified no "open manholes" in this chapter as revised.

Chapter VIII - Issues of Structure in the Standardized Options Market.

This chapter, which we recognize presented some of the most complex issues faced by the Study, consists primarily of (i) a discussion of certain portions of the Securities Exchange Act and its legislative history relating to the development of a national market system, (ii) a discussion of prior Commission actions and releases relating to the development of a national market system and (iii) a discussion of factors which may be taken into account when evaluating market structure issues. The chapter does not purport to answer any of the market structure questions raised by many of the proposals to expand existing options trading programs, or to initiate new options trading programs, and which were publicly perceived as bases for the moratorium. Instead, the chapter is designed to provide maximum flexibility to the Commission.

This approach was apparently adopted in response to instructions not to resolve any of the major structural

issues presented, because definitive recommendations would have required substantial additional time to complete. As a result, the staff and the Commission will need to devote a significant amount of time and effort to resolving the numerous fundamental market structure questions that the chapter discusses before acting upon many of the SRO's proposals to expand options trading. For example, it will probably take a significant amount of additional work to decide whether to permit additional multiple or "dual" trading when the moratorium is lifted.

We believe there are no "open manholes" in the chapter, as revised.

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In order to permit the SRO's to begin work on implementing some of the Study's recommendations as promptly as possible, the Division believes it important to publish the Report as soon as the Commission has had an opportunity to review it. In that review process, we believe that particular attention should be paid by the Commission to the Study's recommendations, with a view to determining which recommendations the Commission should insist be implemented before the moratorium is lifted. We also believe that the Commission should publish the Study Report as a product of the Study staff, without the endorsement of the Commission or its operating Divisions and offices. We believe the Commission's eventual endorsement of the Study's recommendations should be limited, for the present time, to those which it believes must be implemented before the moratorium is lifted. A suitable release with respect to these endorsements and written communications to the SRO's concerning them can then be prepared.

We will submit to you, early next week, our views as to which of the Study's recommendations should be preconditions to the lifting of the moratorium. At that time, we will also give you our best estimate of which recommendations, if implemented by the SRO's, the Division staff realistically will be able to respond to, and process, promptly. We would then like to discuss with the Commission alternative approaches to lifting the moratorium.

Attachment

cc: Commissioners Loomis, Evans, Pollack, Karmel

MEMORANDUM

January 19, 1979

TO : Kathryn B. McGrath
Consultant
Division of Market Regulation

FROM: Richard H. Rowe 
Director
Division of Corporation Finance

RE : The Report of the Options Study Revisions of Recommendation
Concerning Options Prospectus (January 4, 1979)

We have no objection to the recommendation of the Options Study that information included in the OCC prospectus be presented in two parts, separating information about options and trading markets for options from information about OCC. ^{1/} However, we believe that both parts should be filed under the Securities Act of 1933. We feel that it is important that the Securities Act protections and liabilities pertain to all the material information regarding options and feel that it is meaningless to have these protections and liabilities applicable only to the description of OCC which is conceded to be of little concern or use to purchasers of options contracts.

We do not agree with the statements of counsel to OCC, and the apparent concurrence therein by the study, that the liability provisions of the Securities Act have caused the disclosure of material information in the OCC prospectus to be so lengthy and complex as to not meet the needs of option buyers or sellers. We are willing to work with the OCC as well as the Division of Market Regulation in order to develop more simplified disclosure about options and the trading markets for options.

Our preference is to retain the Securities Act disclosure governing options clearing and processing as outlined above; however, if such is not to be done, it is our view that a complete 1933 Act exemption would be better than diluting the disclosure and liability provisions to the extent recommended in the Study's proposals.

^{1/} The Study recommends that the non-OCC document be filed only under the 1934 Act and that it contain "a simple description of the risks and uses of put and call options. This new document should include a glossary of terms; a description of (i) the risks of options trading; (ii) the fundamental uses of options trading; (iii) the terms of options; and (iv) the mechanics of buying, writing and exercising options; and a simplified discussion of transaction costs, margin requirements and tax consequences of option trading."