

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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### COMMISSION RELEASES OPTIONS STUDY REPORT

The Commission released today the Report of its staff's year-long Special Study of the Options Markets.

The 800-page Report was produced by a task force of some 35 persons drawn from 10 different divisions or offices of the Commission, who worked full-time on the project from late 1977 until its completion at the end of 1978. It represents the most comprehensive study yet undertaken of the burgeoning market in standardized stock options.

In his letter of transmittal to the Commission, Study Director Richard L. Teberg said that the Study had found that "options can provide useful alternative investment strategies to those who understand the complexities and risks of options trading.

"But," Mr. Teberg added, "since regulatory inadequacies in the options markets have been found, the Options Study is making specific recommendations needed to improve the regulatory framework within which listed options trading occurs and to increase the protection of public customers."

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The Study made more than 75 specific recommendations for actions to be taken by the Commission, the industry self-regulatory organizations whose members engage in options sales and trading, or both. The recommendations include changes in the Commission's rules; changes in the self-regulatory rules, practices and procedures which govern the conduct of options traders, marketmakers and salesmen; and further study of a number of areas by the Commission staff. Standardized options are currently traded on five exchanges -- Chicago Board Options Exchange, American Stock Exchange, Philadelphia Stock Exchange, Pacific Stock Exchange, and Midwest Stock Exchange. These five, as well as the New York Stock Exchange (where prices on the underlying stocks upon which options are based are usually set) and the National Association of Securities Dealers comprise the self-regulatory organizations whose options-related regulatory activities were examined by the Study.

The Study was ordered by the Commission in October, 1977 as a result of rapid growth in the volume of options being traded on the five options exchanges and the appearance of abuses in trading and sales. At the same time, a voluntary moratorium on expansion of options trading was implemented.

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The Commission expects to issue a statement in the near future setting forth its views with respect to the recommendations of the Study and what action it will take with regard to the pending moratorium on the expansion of the options markets.

The Commission's mandate to the Study directed it to determine the ability of the self-regulatory organizations to carry out their regulatory responsibilities to assure that listed options trading is occurring in a manner, and in an environment, "which is consistent with the maintenance of fair and orderly markets and the protection of investors..."

The Commission also expressed concern about the adequacy of Commission and self-regulatory organization rules to prevent fraud, deception and manipulation in options trading and sales, and about development of the options markets in a manner consistent with development of a national market system.

"In view of the scope and complexity of the matters covered in the Report," Mr. Teberg said in his letter of transmittal, "the Options Study cannot be viewed as providing the definitive answers to all of the questions which need to be answered. In accordance with the Commission's directive to concentrate on the regulatory aspects of the self-regulatory organizations, the Options Study's recommendations are designed to be effective in the options markets as they

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currently exist. Thus, in many respects, the Options Study is merely a beginning. Its efforts should be continued as a part of a regular Commission program of oversight of the options markets."

Specifically with regard to national market system issues, the Report explains that such issues are discussed "with a view toward developing an analytical framework within which they may be evaluated" and that, accordingly, the Study did not make recommendations as to whether the Commission should approve or disapprove any particular rulemaking proposal.

In his letter of transmittal, Mr. Teberg summarized the conclusions of the Study as follows:

While the best of the market surveillance techniques that have been developed would provide a self-regulatory organization with a general ability to detect known improper trading patterns, the Options Study found that numerous improvements must be made in this area to maximize the effectiveness of self-regulatory organizations surveillance. First, the surveillance information available to each self-regulatory organization must be improved. In addition, surveillance information must be better shared among the self-regulatory organizations and surveillance programs should be better coordinated. Further, each self-regulatory organization must evaluate its own surveillance program to assure that it is using the most sophisticated market surveillance techniques available. New and additional data also need to be developed to relate options trading to underlying stock trading not only for current market surveillance purposes, but also to study the patterns, relationships and effects of related stock and options trading.

The Options Study found numerous instances of sales practices abuses in which registered representatives told investors of possible rewards they might expect from options without simultaneously warning them of the risks inherent to options trading. Often, inadequately trained registered representatives recommended options strategies to their customers which it is doubtful that the salesmen, much less their customers, understood. The most prevalent source of sales practice abuses appeared to occur in broker-dealer firms that encouraged or permitted their registered representatives to recommend options trades to their customers before the firms had in place appropriate supervisory controls to protect their public customers.

Although the primary responsibility for assuring that options participants are both informed and treated fairly rests with the brokerage firms, the self-regulatory organizations are required to see that these industry-wide standards are established and met by their member firms. Serious shortcomings were found in the self-regulatory organization's oversight programs to detect and prevent selling practice abuses of their member firms. Representatives of the self-regulatory organizations demonstrated to the Options Study staff their awareness of many of these regulatory problems and their willingness to seek solutions on a continuing basis. The Options Study believes that its recommendations for improved internal controls by brokerage firms, enforced by self-regulatory organizations rules and actively overseen by the Commission will protect investors from many of the selling practices abuses currently found in the options markets, while at the same time fostering better understanding of the risks of options trading by public customers.

Mr. Teberg pointed out that, "during the period of the Options Study, a number of improvements were made in the regulatory programs of the self-regulatory organizations."

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He said that while some of them may have been coincidental with the Study, others "may have represented an acceleration of improvements that would otherwise have occurred" and added: "Unquestionably, many improvements resulted from the increased attention given to finding solutions to deficiencies by both the securities industry and the Commission during the moratorium."

The Report is divided into eight chapters, plus appendixes. Chapter I is the Introduction and includes on pages 11 through 67 a summary of the Study's findings and recommendations. The other seven chapters are as follows:

- Chapter II -- Fundamentals of Exchange Traded Options;
- Chapter III -- The Use of Options by Professional Traders;
- Chapter IV -- Self-Regulatory Organization Surveillance of the Standardized Options Markets;
- Chapter V -- Options Selling Practices;
- Chapter VI -- Self-Regulatory Organization Oversight of Retail Firms and their Associated Persons;
- Chapter VII -- Financial Regulation in the Options Markets; and
- Chapter VIII -- Issues of Structure in the Standardized Options Markets.

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The Options Study was directed by Martin L. Budd from its inception, until Mr. Budd resigned for personal reasons in June, 1978. Mr. Teberg joined the Commission's staff at that time in order to direct the study from then until its completion; he has since returned to the private practice of law.

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