

self-regulatory organization rules which codify it, are meant to serve as a fundamental protection for customers who rely on the judgment and expertise of their brokerage firms and their registered representatives.

Many customers have difficulty comprehending the risks involved in options trading, and, out of necessity, develop a total dependence upon the advice of their registered representatives. In these circumstances, where options customers frequently cannot make informed decisions concerning their own accounts, the responsibility of registered representatives to assure that recommendations made to customers are suitable is all the more meaningful.

a. Traditional concepts of suitability

The suitability doctrine originally developed as an ethical standard of business conduct and was first set down in the 1930s as a guideline to the NASD Rules of Fair Practice. As now incorporated into the NASD rules, it states:

[I]n recommending to a customer the purchase, sale or exchange of any security, a [broker-dealer] member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. ^{16/} (Emphasis added.)

The NASD suitability rule, therefore, requires that member firms have a reasonable basis for believing that a recommendation is suitable, but does not require specifically that firms inquire into the customer's financial circumstances and investment objectives. ^{17/}

^{16/} NASD Rules of Fair Practice, Art. III, § 2, NASD MANUAL (CCH) ¶ 2152.

^{17/} Ibid., "Policy of the Board of Governors", (discusses NASD policies relating to this rule).

The NYSE and AMEX have not adopted rules which directly address suitability of recommendations to buy or sell listed stocks or bonds. However, both exchanges do impose on member firms a duty to use "due diligence to learn the essential facts relative to every customer." 18/ Although this requirement, to "know your customer", might have been designed originally to protect member firms against poor credit risks, it has been interpreted over the years to serve also as protection for customers against unsuitable recommendations. 19/

In 1967, the Commission adopted its own suitability rule, applicable to brokerage firms which are not members of the NASD or of any national exchange. Known as the "SECO" suitability rule, it provides that:

Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other information known by such broker or dealer or associated person. (Emphasis added.) 20/

Unlike the NASD rule, the Commission's rule imposes on brokerage firms a specific affirmative duty to inquire into a customer's circumstances.

18/ Rule 405, 2 NYSE GUIDE (CCH) ¶ 2405; Rule 411, 2 ASE GUIDE (CCH) ¶ 9431.

19/ WOLFSON, at ¶ 2.08[1]; MUNDHEIM, at 451 n.14 and 463 n.54.

20/ Securities Exchange Act Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1977).

b. Suitability developed for listed options

When the CBOE was established in 1973, it adopted a suitability rule which included the traditional standards of suitability and paralleled the Commission's own rule. Therefore, like the Commission's rule, the CBOE rule imposes on brokerage firms a specific affirmative duty to conduct reasonable inquiry into a customer's circumstances and to have reasonable grounds for believing that a recommendation is not unsuitable for the customer.

In addition, the CBOE rule included additional and more stringent suitability standards to recognize the potentially greater risks inherent in uncovered call writing transactions. When the rule was amended in 1977 to include puts, these standards were also made applicable to recommendations for put writing transactions. These additional requirements provide that:

[A] recommendation to a customer of [writing a put or an uncovered] call option contract, shall be deemed unsuitable for the customer unless, upon the information furnished by the customer, the person making the recommendation has a reasonable basis for believing ... 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 such transaction, and such financial capability as to be able to carry such position in the option contract. 21/ (Emphasis added.)

The most significant difference between this standard and the traditional standard applicable to supposedly less risky options transactions

21/ Rule 9.9, CBOE GUIDE (CCH) ¶ 2309.

is that this new standard requires that the firm have a reasonable basis for believing that the customer is sophisticated enough in financial matters to understand the risks of uncovered call writing and put writing strategies. The rule relating to other options strategies requires no such finding.

Other self-regulatory organizations have adopted suitability rules similar to the CBOE's, both with respect to general options trading and to the more risky uncovered call writing and put writing strategies. 22/

The Options Study believes that the current suitability standards applicable to options transactions should be strengthened in the following ways:

(1) A Finding that the Customer is Capable of Evaluating the Risks of Options Transactions

The current options prospectus states on the cover page in bold-face type:

Both the purchase and writing of Options involve a high degree of risk and are not suitable for many investors. Such transactions should be entered into only by investors who have read and understand this

22/ Rule 923, 2 ASE GUIDE (CCH) ¶ 9723; Art. XLVM, Rule 5, MSE GUIDE (CCH) ¶2115; Rule X, Sec. 18(c), PSE GUIDE (CCH) ¶ 4993; Rule 1026, PHLX GUIDE ¶ 3026. Unlike the CBOE rule, the suitability standards of the other options exchanges apply to all transactions in put or uncovered call writing, whether or not recommended. This means that the firm must refuse to effect any unsolicited transaction in either put or uncovered call writing unless the firm has a reasonable basis for a suitability determination.

prospectus and, in particular, who understand the nature and extent of their rights and obligations and are aware of the risks involved. (Emphasis added.)

As discussed above, the options exchanges do not require that a broker-dealer recommending options transactions to a customer have a reasonable basis for believing that the customer understands the risks of the recommended transactions, except when the particular recommendation or transaction is to write uncovered calls or to write out options.

The Options Study believes that a customer should be made aware, on an on-going basis, of the risks of any and all options transactions undertaken by the customer and that a brokerage firm should not be permitted to recommend any options transaction to a customer unless the firm reasonably believes that the customer is capable of both evaluating the risks and bearing the financial burden of those risks.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD REVISE THEIR OPTIONS CUSTOMER SUITABILITY RULES TO PROHIBIT A BROKER-DEALER FROM RECOMMENDING ANY OPENING OPTIONS TRANSACTIONS 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.

(2) An Affirmative Requirement to Obtain Suitability Information Before Recommendations are Made

A broker-dealer's duty of "reasonable inquiry" under the suitability rules requires that the firms at least ask the customer for suitability information. If a customer refuses to furnish this information, the

firm must, nevertheless, have "reasonable grounds" on which to base a suitability determination.*

The CBOE guidelines make clear that "[m]aking a recommendation without knowing the customer's essential facts or other information will result in the recommendation being unsuitable." 23/ However, these guidelines do permit options transactions to be recommended to a customer who refuses to furnish suitability information, provided the firm has other information indicating that the recommended transaction is not unsuitable for the customer.

Estimating suitability information for a customer who refuses to furnish this information can result in the same problems that occur when a registered representative fails to inquire into a customer's background. Unless sufficiently comprehensive customer information is actually obtained, suitability determinations cannot be made.

Accordingly, to clarify and strengthen firms' obligations to obtain suitability information for customers, the Options Study recommends:

THE RULES OF THE SELF-REGULATORY ORGANIZATIONS
SHOULD BE AMENDED TO PROHIBIT FIRMS FROM RECOM-
MENDING OPENING OPTIONS TRANSACTIONS TO ANY CUSTOMER WHO

23/ CBOE Educational Circular #6, at 10.

* For a more detailed discussion of the amount of information necessary to form reasonable grounds for a suitability determination, see p. 62 below.

REFUSES TO PROVIDE INFORMATION, AND FOR WHOM THE FIRMS DO NOT OTHERWISE HAVE INDEPENDENTLY VERIFIED INFORMATION SUFFICIENT FOR THE SUITABILITY DETERMINATION.

c. Account opening rules

The existing suitability rules require that a brokerage firm ask its customers for certain information and use the information obtained, along with any other information known about the customer, in determining whether recommended options transactions are suitable for that customer. In an attempt to assure that such information is obtained and used, all the options exchanges have adopted rules which require that before a customer is permitted to trade options, his brokerage firm must make an initial determination that listed options trading is not unsuitable for him.

The CBOE's "know your customer" rule is a typical options exchange account opening rule. It requires that suitability information be obtained, recorded, and used by a brokerage firm in determining whether to approve the account for options trading:

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, financial situation and needs. A record of this information shall be maintained by the member organization and, based upon such information, a Registered Options Principal who is an officer or partner of the member organization shall approve in writing the customer's account for options transactions.... 24 /

Other self-regulatory organizations have adopted similar account opening rules. 25/

d. Summary

In conjunction with account opening requirements, current suitability standards applicable to a firm's initial determination of the general suitability of options trading for a customer, and of specific transactions after the customer is approved for options trading, can be summarized as follows:

(1) The brokerage firm generally must acquire, use and maintain a current record of information regarding the customer's background, financial resources and investment objectives.

(2) Using the information thus acquired, the brokerage firm must make three determinations:

(a) does the customer have sufficient financial resources to bear the risks of a recommended transaction;

(b) are the risks of a recommended transaction appropriate in light of the customer's investment objectives; and

(c) with regard to recommendations of put or uncovered call writing transactions, is the customer sufficiently sophisticated to enable him to comprehend the risks involved in such transactions.*

25/ Rule 921, 2 ASE GUIDE (CCH) ¶ 9721; Art XLVIII, Rule 3, MSE GUIDE (CCH) ¶ 2113; Rule X, Sec. 18(b), PSE GUIDE (CCH) ¶ 4993; Rule 1024(b), PHLX GUIDE (CCH) ¶ 3204.

* As noted above, the Options Study believes this requirement should be made applicable to all recommended transactions.

The Options Study has found violations of these standards throughout the industry.

3. Acquisition of Information

a. Accuracy

A firm's first step in making a proper suitability determination is to obtain the required information from its customers. This information is then usually transferred to an account information form and retained by the firm.

Although the requirement that firms obtain this information is explicit in the self-regulatory rules, firms nevertheless evade it in several ways. First, a majority of the firms surveyed by the Options Study permit registered representatives to estimate customers' financial suitability information when opening accounts for options trading, rather than insisting that the registered representative obtain exact information from his customers. Second, when existing securities accounts are converted to options trading, many firms have a practice of simply transferring the information on the customer's original, and often outdated, account opening card to the new account approval form for options. Finally, registered representatives may deliberately overestimate their customers' financial status in order to gain from their supervisors approval of those accounts for options trading.

As a result of these practices, it is not uncommon to find inaccurate suitability information about a customer contained in the files of broker-dealer firms. The Options Study found one situation in which a registered representative had estimated his customer's annual income at \$15,000 to \$20,000 and her net worth at \$70,000, when in fact she earned \$12,000 and her entire net worth consisted of the \$20,000 equity in her home. In another case, one set of firm records showed a customer's net worth as \$250,000 while another set of the firm's documents showed the same customer's net worth as only \$30,000.

One registered representative testified that she had estimated a client's income to be substantially higher than it actually was and that, had she known the customer's true financial situation, she would have urged a more conservative investment approach. Another registered representative admitted that he never asked one of his customers for the customer's net worth but instead made a suitability determination based on a "first impression" of the customer's business knowledge, dress, and sophistication in discussing securities and strategies. Unknown to the registered representative, this customer was a retired medical consultant with limited resources and an annual income of only \$6,000 per year. The registered representative also mistakenly assumed the customer's investment objective to be capital gains instead of income.

Inaccurate suitability information in a firm's files prevents a firm's supervisory personnel from fulfilling their responsibility to make reasoned determinations of the suitability of options trading for

the firm's customers generally and for particular options transactions. As a consequence, customers can become involved in options transactions totally unsuitable to their means. A sample of such cases includes:

- . an 18 year old student away at college who was allowed to trade listed options and lost approximately \$2,200 of tuition money. This student had been turned down for options trading in his hometown office of the same firm by a registered representative who handled his parents' securities account;
- . a welfare recipient who was engaged in a strategy of selling calls covered only in part by warrants on the underlying stock;
- . a widowed, retired school teacher who was allowed to engage in advanced options strategies from which she lost one half of her life savings.

Many customers never see the financial and other data which supposedly form the "reasonable basis" for a determination of their options suitability. Inaccurate information about options customers might be corrected if all firms enabled customers to verify personally their account information. Although some firms either: (1) send a copy of the suitability information to the customer for his verification, or (2) check with a credit agency, bank or other credit reference in order to determine the veracity of customer suitability information, many firms surveyed by the Options Study make no such attempt.

To correct this situation, the State of Wisconsin has required that firms furnish every customer with a conformed copy of all agreements between the firm and the customer and with a copy of the prescribed customer information form. 26/ In order to conform with the Wisconsin

26/ Wisc. Admin. Code § 4.05(7).

statutes, several brokerage firms send a copy of the customer information forms to their customers in Wisconsin, but have chosen not to expand this practice to customers located in other states.

The Options Study believes all firms should be required to verify the accuracy of such information by sending a copy of the completed form to the options customer. It is important, however, that procedures for verification not be regarded as a means for lessening the broker-dealer's responsibility to obtain accurate and comprehensive suitability information.

In an effort to improve the accuracy of recorded suitability information, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR OPTIONS ACCOUNT OPENING RULES TO REQUIRE THAT (1) THE MANAGEMENT OF EACH FIRM SEND TO EVERY NEW OPTIONS CUSTOMER FOR HIS VERIFICATION A COPY OF THE FORM CONTAINING THE CUSTOMER'S SUITABILITY INFORMATION; AND (2) THE SOURCE(S) OF CUSTOMER SUITABILITY INFORMATION, INCLUDING THE BASIS FOR ANY ESTIMATED FIGURES, BE RECORDED ON THE CUSTOMER INFORMATION FORMS.

b. Sufficiency

Not only is a firm's information about its customers sometimes inaccurate, it can also be severely lacking in content. Although none of the options suitability rules specify the amount of information necessary to form a reasonable basis for a suitability determination, "Educational Circular #6" prepared by the CBOE suggests the type of customer information which a firm should record in writing:

Inquiry should attempt to determine pertinent facts about the customer. Some facts which may be considered pertinent are the client's marital status, dependents, occupation, major sources of income, investment objectives, net worth, investment experience, and ability to understand and evaluate the risks of options transactions. A written record of the essential facts must be maintained by the firm.... 27/

Attached to the CBOE circular is a checklist of information that the firm might wish to obtain during its customer inquiry, such as occupation; net worth; dependents; annual income; past investment experiences in both options and other securities (specifying size, frequency of transactions, type of transactions, and years of experience); and investment objectives.

The AMEX publishes a similar checklist which, in addition to the information required by the CBOE, suggests that a firm distinguish between a customer's income from employment and his income from other sources; identify whether the customer rents or owns his own home; and obtain the customer's net worth exclusive of family residence, as well as his liquid net worth, insurance, and previous and current brokerage accounts (including type and degree of activity). 28/ The AMEX guidelines require, in addition, that the customer's refusal to furnish all the information necessary for account approval be noted on the customer's account form. 29/

27/ CBOE Educational Circular #6, at 2.

28/ AMERICAN STOCK EXCHANGE, ATTACHMENT TO REGULATORY GUIDELINES FOR CONDUCTING A PUBLIC BUSINESS IN AMEX LISTED OPTIONS (PUTS AND CALLS), (MAY, 1977) [hereinafter cited as AMEX REGULATORY GUIDELINES].

29/ Id. at 4.

Evidence suggests that firms do not follow these exchange guidelines. In some cases, the problem might be solved by a simple exercise in draftsmanship, in that some firms' account forms for options customers do not have places for the transcribing of information specified by the self-regulatory organizations. For example, some forms do not have a space in which a customer's net worth or occupation can be disclosed, and many do not provide room to record liquid net worth, dependents, or previous investment experience.

In other cases, however, firms seem to shield themselves from information about customers which might bear on suitability. Registered representatives are not encouraged or required to be candid about a prospective customer's circumstances even though registered representatives are often in possession of unique suitability information. The Options Study reviewed several situations where this lack of candor prevented critical facts concerning a customer's circumstances from being revealed to the supervisors who had to make the appropriate suitability determinations. For instance, the Options Study found the following examples of customers whose information forms suggested financial resources for options trading, but who had other, unrecorded problems which were generally known to their registered representatives and which raised questions about the suitability of options for them:

- A retired couple with assets of more than \$100,000 and income of \$12,000, but where the husband was fully disabled, was receiving outpatient mental care, and where the couple had an adult retarded child fully dependent on them;

- . A woman who appeared to have adequate resources to engage in options trading but who appeared to be mentally unstable, extremely nervous and confused, and had no understanding of financial matters nor family or friends to help her;
- . A twenty-year old who appeared to have substantial assets, but who was completely unsophisticated in securities matters and whose net worth consisted of an inheritance resulting from the death of both parents and upon which he depended for income;
- . Several customers with varying financial resources and prior securities investment experience, but who spoke no English;
- . Several investors who appeared to have substantial assets to invest, but who were widows with small children and whose assets were a family house and their husbands' life insurance proceeds.

In other cases, registered representatives did not completely fill out the suitability forms. A recent examination at one major retail brokerage firm revealed that 69 percent, or 62 out of the 90 sampled options customer information forms, were lacking information as to net worth, annual income or investment objectives. Similarly, an NASD survey indicated that some of its members have failed to maintain sufficient suitability information.

Firms sometimes argue that incomplete records of suitability information do not necessarily indicate that the firm does not have complete information. Rather, they urge, the account may have been approved on the basis of information not disclosed on the form. But failure of a firm to record all of the pertinent information upon which a suitability determination is based makes virtually impossible the supervisor's task

of adequately reviewing an office's compliance with account opening and suitability standards. In addition, without properly recorded suitability information, the self-regulatory organizations cannot detect suitability or account opening abuses occurring within member firms.

Several brokerage firms allocate space on their account opening or account information forms for the registered representative to note certain matters of relevance to the firm's promotional efforts, such as how the account was acquired and whether to send various solicitation materials to the customer. Accordingly, it should not be burdensome to require that brokerage firms use customer information forms to obtain the suitability information already recommended by exchange guidelines and to provide space on the forms where the registered representative must record any special matters which bear on a particular customer's suitability.

In order to assure more diligent inquiry into a customer's background for suitability purposes, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR OPTIONS RULES (1) 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; (2) 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.

c. Timely review of suitability information

Exchange rules require that an account be approved for options trading before a firm accepts any options order from a customer. The account must be approved in writing by an ROP who is an officer or partner of the firm, but in the case of a branch office:

an account may be approved for options transactions by the manager of such branch offices, in which event the action of the branch office manager shall within a reasonable time be confirmed by the Registered Options Principal. 30/

To comply with this requirement, many firms have their registered representatives fill in the customer information form which, along with the other account opening documents, is reviewed by the branch manager who approves the account for trading. But the manager is not always an ROP, and he does not always have sufficient options expertise to properly evaluate the customer information for suitability purposes. Although the home office ROP may eventually reject the account or limit the account's trading to certain options strategies, the account is, meanwhile, permitted to trade options and may be engaging in unsuitable transactions. In some instances, several months may pass before an ROP reviews the account.

The Options Study believes that the recommendation in Subchapter "B" of this chapter, "Supervision of Accounts", that all branch managers

30/ Rule 9.7(b), CBOE GUIDE (CCH) ¶ 2307.

be ROP qualified, may alleviate the problem of untimely review by a qualified employee for approval of new customers for options trading.

4. Problems of Continuing Supervision

A firm's responsibilities regarding suitability do not end after it has made the initial suitability determination and has permitted a customer to open an options account and commence options trading. Exchange rules require the firm to make continuing suitability determinations with regard to each recommended options transaction. In addition, the rules of all options exchanges, other than the CBOE, also require a similar determination with regard to all put writing or uncovered call writing transactions, whether or not recommended. To fulfill these responsibilities, firms need: (1) to assure that suitability information is appropriately updated; (2) to establish adequate account review procedures; and (3) to maintain customer suitability records in locations which assure their availability for use.

a. Current suitability information

Information obtained from a customer at the time an account is opened frequently becomes outdated for a variety of reasons. As a customer continues to trade listed options, his increased knowledge and understanding of the risks involved in options trading may help alter his investment objectives and, therefore, the suitability of various types of options trading for him. In addition, a registered representative's relationship

with his customer may develop over a period of time, enabling the registered representative to learn additional information about his customer's financial situation and investment objectives. And, of course, the financial resources of customers may change with time.

Rarely, however, are customer account opening forms updated to reflect changes in the customer's financial information, investment objectives, or financial sophistication. In almost all firms surveyed by the Options Study, account opening documents are reviewed to assure that they contain current information only when a serious question arises concerning the account.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR
RULES TO REQUIRE THAT MEMBER FIRMS SEMI-ANNUALLY
CONFIRM THE CURRENCY OF CUSTOMER SUITABILITY
INFORMATION.

b. Account review procedures

As discussed in subchapter "B", "Supervision of Accounts", most firms traditionally have placed primary responsibility for supervision of customer accounts on their branch office managers where the incentive to supervise may be absent, and the manager's understanding of options may be in doubt. Even where the manager is competent and properly motivated, however, the task of performing adequate account reviews without assistance is difficult, particularly in offices which do a high volume of options business. Some firms have recognized the need to provide help to branch

managers and have developed computer-assisted programs to support branch managers in performing account reviews. In some firms, the computer runs are reviewed by home office compliance personnel and in others they are given to the branch office manager to assist him in his review of customer accounts. Some of these programs have a particular relevance to options and include:

- (1) daily exception runs to identify customer options transactions in customer accounts not approved for options trading;
- (2) daily exception runs to highlight customer options transactions which fall outside the types of options investment strategies for which the customer is approved;
- (3) monthly or quarterly runs to identify all customer accounts which generated more than a specified amount in commissions, or which undertook more than a specified number of options transactions, or both.

A few firms have begun to use computer programs which correlate a customer's transaction activity with financial and other data concerning the suitability of options trading for him, eliminating the need for cumbersome manual cross referencing of trading with background information. Several firms employ computer runs which show increases or decreases in customer equity on a periodic basis and by year-to-date.

On the whole, however, the Options Study found account review procedures employed by brokerage firms to be inadequate to assure a firm's adherence to suitability requirements. First, not all firms have developed automated methods of reviewing customer accounts. Some firms, even a few with multi-million dollar revenues from their options business and thousands of customers approved for options trading, appear to rely heavily on clearly antiquated manual spot-checks, and other "random" samplings to review customer options activity. For example, one firm with more than \$1.3 million in options revenues in 1977, and more than 1,200 customers approved for options trading, informed the Options Study that it conducts only monthly branch office and quarterly home office random manual reviews of customer accounts. Another firm, with more than \$800,000 in options commission revenues in 1977, and 2,500 customers approved for options trading, appears to have almost completely abdicated its account review responsibilities, conducting only an annual review of a random manual selection of customer accounts.

Second, while some firms have developed account review programs specifically related to options, many still use only account review procedures developed to detect problems involving stock trading in customer accounts. Certain of these stock account review procedures are useful in detecting problems relevant to customer options trading (e.g., excessive trading and commission reviews), but, in general, these programs cannot detect options trading activity which entails

large or rapid increases in risk to a customer account. Adaptations of customer credit monitoring systems by some firms have not always been a dependable means of monitoring customer risk.

To illustrate this problem, the Options Study identified several types of options transactions in customer accounts which normally indicate precipitous increases in customer risk and may signal unsuitable trading strategies, and asked the firms in the industry group sample whether they had procedures designed to detect such trading. The activities include: "Leg-Lifting" in spread positions,* converting covered call positions to uncovered call positions, large scale writing of uncovered call options, and exercises of long call positions prior to expiration week. The chart below shows the responses of the firms.

FIRM HAS PROCEDURES TO DETECT:	<u>YES</u>	<u>NO</u>
"Leg-Lifting" in spread positions	46%	54%
Converting covered call positions to uncovered call positions	50%	50%
Large scale writing of uncovered call options	79%	21%
Exercises of long call positions prior to ex- piration week	46%	54%

* An options "spread" position consists of a "long" side, i.e., the holder of the position has purchased an option, and a "short" side, i.e., the holder of the position has also sold an option. Each side of the position is called a "leg". If one side of the position is closed, as for example, if the holder sells the options in the long "leg", the leg is said to be "lifted", hence the expression, "leg-lifting." Once one leg is lifted, the investor is exposed to risks inherent in other leg.

These data suggest that many firms are unable to detect trading practices which are of themselves warning signs of unsuitable transactions. The Options Study believes that implementation of its recommendations concerning account review procedures made in subchapter H, entitled "Options Trading in Customer Accounts" will help to ensure that brokerage firms have such a capability.

c. Keeping suitability records

Rule 17a-4 under the Exchange Act requires that firms maintain all customer account information during the life of an account (and for six years after the account is closed). One obvious purpose for the requirement is to enable firms to assist customers in pursuing investment programs suitable to their needs. This purpose can be thwarted, however, if the information is not kept at locations where it actually can be used. At present, Rule 17a-4 and the equivalent rules of self-regulatory organizations do not specify that the records be kept at any particular place. As a consequence, many firms have not adopted record maintenance policies which assure that the account information will be kept in the places where it is needed.

Perhaps because most self-regulatory organizations inspect the home office of a firm far more frequently than branch offices, many firms retain records of customer account statements, background and financial information only at the home office. Yet, since most investment recommendations for customers are made at the branch offices, the

Options Study believes that the information is also needed there. In addition, unless branch managers have access to and use such information in reviewing customer transactions for suitability, such reviews are of questionable value.

The Options Study has been told by some in the industry that no useful purpose would be served by requiring that background and account information be retained at the sales office level. If the branch is small, the argument goes, a manager's personal knowledge of his customers provides an adequate basis for assessing suitability; and if the branch is large, customer transactions are too voluminous to permit the manager to cross-reference a customer's trading with account, background and financial information.

These arguments are not persuasive. Regardless of the utility of the information for supervisory reviews, the information should be available to registered representatives who make recommendations and give advice to customers before orders are entered. In addition, while there may be instances in which the branch manager's personal knowledge of his branch's customers obviates the need for recorded information, the Options Study has reviewed too many cases of unsuitable trading to conclude that a manager's "personal" knowledge serves as an adequate basis for conducting suitability reviews. Indeed, these cases suggest that if the registered representatives knew that the sales manager had ready access to suitability information, they might have refrained from effecting obviously unsuitable trades in customer accounts.

As for the argument that such information, however relevant, is simply ignored in larger offices because of time pressures, the solution for the firm is not to disregard valuable information, but to develop adequate and perhaps automated procedures to supervise properly the options business transacted by customers of the firm.

Moreover, the need for account, background and financial information to be available at broker-dealer sales offices transcends the value of such information to the firm itself. During a recent special sales office inspection program conducted by the Commission's staff, during which more than 150 sales offices were inspected, the Commission's staff repeatedly encountered difficulties in conducting proper reviews because customer account and background information was unavailable. Obviously, the task of Commission and self-regulatory organization inspectors in adequately reviewing the suitability of trading in customer accounts at a branch office would be made far easier — and would be accomplished more quickly — if customer account information were available for review at the branch. Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS 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.