

# NASD

NOTICE TO MEMBERS 80-22  
Notices to Members should be  
retained for future reference.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

June 4, 1980

## M E M O R A N D U M

TO: All NASD Members  
ATTN: Registered Options Principals  
RE: New Options Rules

### SUMMARY

On May 15, 1980, the Securities and Exchange Commission approved numerous options rule change proposals submitted by the Association in response to certain recommendations of the SEC's Special Study of the Options Markets (the "Options Study").\* The rule changes affect the Association's options "access firm" program which was implemented on February 1, 1979, and are therefore applicable to the following NASD members:

- those who engage in transactions involving exchange listed options while not a member of an exchange on which the options they trade are listed; and,
- those who engage in transactions involving conventional, over-the-counter options.

The proposals had been circulated for member comment on three separate occasions - May 16, August 17 and August 31, 1979 - and were formally filed with the SEC on December 7, 1979. Most of the new rules were also discussed at seminars conducted nationwide during the weeks of March 3 and 10, 1980.

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\* On March 26, 1980, the SEC approved similar rule change proposals submitted by the Chicago Board Options Exchange and the American, Midwest, New York, Pacific and Philadelphia Stock Exchanges.

Included in this notice are an explanation of each of the rule changes, the complete text of the rules and a timetable which indicates the specific dates on which each of the rules is to become effective. In this connection, members should note that some rule changes are effective immediately while others will take effect on June 16, July 15, August 15 and November 14, 1980, respectively.

Members are urged to review each of these rule changes carefully and take appropriate steps to ensure that they will be able to comply with them by their designated effective dates. While all members are expected to be in compliance with the new requirements at the time they become effective, the Association will consider individual requests for extensions of time beyond the stated effective dates where good cause is shown and/or where extenuating circumstances warrant such an extension. All requests for extensions of time must be submitted in writing and must include an explanation of the reason(s) therefor. Requests should be addressed to:

S. William Broka, Assistant Director  
Department of Regulatory Policy and Procedures  
National Association of Securities Dealers, Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006

In connection with the implementation of the new options rules, members are also urged to insure that all of their registered personnel who are involved in handling or supervising options activities become thoroughly familiar with them. In order to assist members in this regard, the Association, together with the other self-regulatory organizations who have adopted similar requirements, has prepared a booklet entitled: Handling Options Transactions for Public Customers. A copy of this booklet will be mailed to each member under separate cover.

### EXPLANATION OF THE RULES

#### Appendix E to Article III, Section 33 of the Rules of Fair Practice

(No changes have been made to Sections 1 through 15 of the Appendix)

Section 16 of Appendix E has been amended to expand the information which members must disclose on statements of account sent to customers having a general (margin) account. Statements sent to such customers must reflect the mark-to-market price and market value for all security positions in the account, the total market value of all positions in the account, the debit (or credit) balance and the account equity. General (margin) account equity has been defined as the difference between the total of long security values, including any credit balance, and the total of short security values, including any debit balance. While the above requirements apply only to margin account customers, additional amendments have been made in Section 16 which will require all customer account statements (cash and margin) to include the following: interest and any special charges assessed against the account during the period covered by the statements

(only to the extent, however, that such charges have not already been itemized on transaction confirmations); a legend to the effect that information concerning commissions and other charges, although included in individual confirmations, will again be furnished to customers upon request; and, a legend asking that customers notify the member of any changes in their financial situation.

A new Interpretation of the Board of Governors has been added to Section 17 listing, among other things, specific categories of minimum information that a member must seek to obtain before opening an options account for a customer who is a "natural person" (i.e., not a corporation or institution). Such minimum information includes the customer's investment objectives, employment status, estimated annual income, estimated net worth, marital status and number of dependents, age and investment experience and knowledge. In addition, pursuant to this Interpretation, customer records must contain, if applicable, the source or sources of background and financial information concerning the customer, discretionary authorization, the date the Options Clearing Corporation prospectus was furnished to the customer, the nature and types of transactions for which the account is approved, the name of the registered person handling the account, the name of the Registered Options Principal approving the account and the date of such approval and the dates of verification of each item of information noted above.

Verification of background and financial information is required for all natural person customers. Pursuant to subsection (c) of Section 17, every such customer must be sent for his verification the background and financial information reflected in his customer account information form within 15 days of the approval of his account for options trading unless such information is included in the written account agreement required to be obtained pursuant to subsection (d) hereof. In addition, this information must again be sent to the customer for verification whenever the member becomes aware of any material change in the customer's financial situation. These verification requirements extend to existing as well as new options customers of a member, although a one year lead time has been provided in which to verify information on existing customers. A "negative verification" provision has also been included in this Section pursuant to which information sent to a customer by a member for verification will, absent advice from the customer to the contrary, be deemed to be correct.

As a result of these and other changes made in Appendix E, existing subsections 17(b)(2) through 17(b)(5) and existing Interpretation .01 have been deleted from the rule.

A new Section 18 has been added to Appendix E which imposes specific recordkeeping requirements on members doing an options business. Under subsection 18(a), members must maintain a central, firm-wide file of all options-related customer complaints containing specified information concerning each complaint. Such information includes: identification of the complainant; the date the complaint was received; identification of the registered person servicing the account; a general description of the matter complained of; and, a record of any action taken by the member with respect to the complaint. Copies of the complaints themselves would also have to be forwarded to and maintained at the same central location. In addition, a copy of every options-related complaint would have to be maintained in a separate file at any branch office that is the subject of the complaint.

New subsection 18(b) states that background and financial information of customers approved for options trading must be maintained both at the branch office and at the principal supervisory office having jurisdiction over the branch office. In addition, this subsection requires that monthly customer account statements for the most recent six months be maintained at both such offices and that other records necessary to the proper supervision of accounts also be made easily accessible thereto.

(Existing Sections 18 through 23 of Appendix E have been renumbered 19 through 24 as a result of the addition of new Section 18 to the Appendix.)

Section 19 has been amended to require that the Senior Registered Options Principal (SROP) of a member review the acceptance of each discretionary account to determine whether the ROP accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the proposed strategies or transactions.

Existing subsection 19(c) has been deleted from Appendix E. This provision was viewed as unnecessary in light of the newly adopted and more stringent suitability criteria contained in Section 20 and discussed more fully hereafter. A new subsection (c) has been added to the rule which requires members to furnish to customers over whose accounts they exercise investment discretion a written explanation of the risks involved in the systematic use of one or more options strategies in such accounts. This requirement applies to existing as well as new options customers.

As noted above, Section 20 of Appendix E has been amended to make applicable to all recommended opening options transactions the more stringent suitability requirements (that the customer be able to evaluate the risks of the transaction and be financially able to bear them) that now apply only to recommendations for uncovered call writing or put writing. Under the amended suitability rule, a member would be prohibited from recommending any opening options transaction to a customer unless these requirements are met.

Under amendments to Section 21(a), members are required to develop and implement a written options account review program and to place such a program under the direct supervisory control of the firm's SROP. In addition, three new subsections have been added to Section 21. Subsection (b) develops the concept of a Compliance Registered Options Principal (CROP) - a ROP qualified individual having no sales functions who shall be responsible to review and to propose appropriate action to secure a member's compliance with applicable securities rules, regulations and laws. The CROP will be required to furnish regular reports directly to the firm's Compliance Officer and other senior management personnel. An exemption from the non-sales requirement for CROP designations has been provided for those members with less than \$1 million in options commissions in either of the preceding two fiscal years and/or those with ten or fewer registered persons handling options accounts.

Pursuant to subsection (b), every member must designate a CROP and identify such person to the Association. To assist members in meeting their obligations under this rule, the Association has developed a special CROP designation form. The form, together with instructions, will be mailed to each member under separate cover.

New subsection (c) requires every manager of a branch office which conducts a public options business to be qualified as a Registered Options Principal. An exception to this requirement is provided for branch offices which have three or fewer registered persons handling options accounts and which are otherwise under the supervision of a ROP.

Under new subsection (d), members are required to maintain, at the principal supervisory office having jurisdiction over customers' accounts, sufficient information to enable them to make a number of compliance-related determinations with respect to the options activity in each such account. These include, among others, the size and frequency of options transactions, commission activity and the amount of profit or loss for each customer account.

(Existing Sections 21 through 23 of Appendix E, although renumbered 22 through 24, are otherwise unchanged)

Article I, Section 2(d), Schedule C  
of the By-Laws

Part I of Schedule C has been amended to provide a cross reference to the requirements concerning designation of Senior and Compliance Registered Options Principals contained in Section 21 of Appendix E.

In addition, a new Part VIII has been added to Schedule C which requires members to inform the Association in writing of any disciplinary actions taken by any national securities exchange or association, clearing corporation, commodity futures market or government regulatory body against them or their associated persons. Members are also required to notify the Association of any disciplinary actions which they take against their registered persons involving suspension, termination, the withholding of commissions or the imposition of fines in excess of \$2,500 or any other significant limitation on such persons' activities.

Uniform Practice Code


Section 63 of the Code has been amended to require members who choose to utilize a random allocation of exercise assignment notices to use either an approved automated method, or the manual method that has been specified by the Association. First-in-first-out (FIFO) methods of allocation are allowed provided they satisfy the standards for a valid FIFO method established by the Association. In addition, members are required under new subsection (c)(3) of Section 63 to notify their customers of the method of allocation which they utilize explaining how such method works. This latter provision, involving notification of a member's allocation procedures, is applicable to existing as well as new options customers.

The Association, in conjunction with the other self-regulatory organizations who have adopted similar requirements for exercise notice allocation, has prepared a circular which describes in detail all of the acceptable assignment procedures. That circular will be mailed shortly to each member under separate cover.

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Members are again urged to review this notice and each of the new rule changes carefully, paying particular attention to the scheduled effective dates of each provision. Should you have any questions with respect to any of the new requirements outlined herein, please contact S. William Broka, Assistant Director, Regulatory Policy and Procedures at (202) 833-7247.

Sincerely,



Gordon S. Macklin  
President

Attachment

Article III, Section 33, Appendix E  
(Additional material is underlined, deleted language is indicated by brackets)

Sections 1 through 15 - No change

Section 16 - Statements of Account (November 14, 1980)\*

Statements of account showing security and money positions [and], entries, interest charges and any special charges that have been assessed against such account during the period covered by the statement shall be sent no less frequently than once every month to each customer in whose account there has been an entry during the preceding month with respect to an option contract and quarterly to all customers having an open option position or money balance. Interest charges and any special charges assessed during the period covered by the statement need not be specifically delineated if they are otherwise accounted for on the statement and have been itemized on transaction confirmations. With respect to options customers having a general (margin) account, such statements shall also provide the mark-to-market price and market value of each option position and other security position in the general (margin) account, the total market value of all positions in the account, the outstanding debit or credit balance in the account, and the general (margin) account equity. The statements shall bear a legend stating that further information with respect to commissions and other charges related to the execution of option transactions has been included in confirmations of such transactions previously furnished to the customer, and that such information will be made available to the customer promptly upon request. The statements shall also bear a legend requesting the

\* Indicates effective date of the rule change.

customer promptly to advise the member of any material change in the customer's investment objectives or financial situation.

For purposes of this Section, general (margin) account equity shall be computed by subtracting the total of the "short" security values and any debit balance from the total of the "long" security values and any credit balance.

#### Section 17 - Opening of Accounts

(a) Approval Required - No member or person associated with a member shall accept an order from a customer [for the] to purchase or [sale (writing) of] write an option contract unless the customer's account has been approved for options trading in accordance with the provisions of subsections (b) [and (c)] through (d) hereof. (May 15, 1980)

#### (b) Diligence in Opening Accounts

[(1) Before] In approving a customer's account for options trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives. Based upon such [facts] information, the [member or a general partner or officer of the member who is a] branch office manager or other Registered Options Principal [and who is personally informed of such essential facts] shall specifically approve or disapprove in writing the customer's account for options trading; provided, [however,] that [in the case of a branch office, an account may be approved for options trading by the manager of such branch office, in which event the action of such] if the branch office manager is not a Registered Options Principal, account approval or disapproval shall within [seven (7)] ten (10) business days be submitted to and approved or disapproved by a Registered Options Principal. A record of the information obtained pursuant to this Section and of the approval or disapproval of each such



account shall be maintained by the member as part of its permanent records in accordance with Section 18 of this Appendix E. (June 16, 1980)

(2) In connection with approving the account of a customer for options trading, members should seek information in particular as to whether the customer has had prior experience in trading options, whether he is aware of the nature and extent of the obligations as well as the risks attendant to options trading, whether he has accounts with other brokerage firms and the extent of any positions or commitments therein, and whether the customer has financial resources adequate to cover option positions he may intend to establish in such account.

(3) Before approving an account of a trust, pension fund, profit sharing plan or other fiduciary for options trading, a member shall obtain written evidence that the instruments under which the fiduciary is acting permit options trading.

(4) Before approving an account with respect to which trading authorization has been granted to a third person who is not an employee of the member for options trading, the member shall obtain written evidence of the agent's authority to act and that such authority specifically includes options trading.

(5) Before approving an account of an investment partnership or an investment club for options trading, the member shall obtain written evidence of the authority of the person signing the agreement required by this Section to sign such agreement on behalf of such partnership or club, as the case may be, and that such authority specifically includes options trading. Information shall also be obtained with respect to any current long or short option positions of the respective partners or members of the partnership or investment club.]

(c) Verification of Customer Background and Financial Information.

The background and financial information upon which the account of every new options customer that is a natural person has been approved for options trading, unless the information is included in the customer's account agreement, shall be sent to the customer for verification within fifteen (15) days after the customer's account has been approved for options trading. A copy of the background and financial information on file with a member shall also be sent to the customer for verification within fifteen (15) days after the member becomes aware of any material change in the customer's financial situation. (July 15, 1980)

[(c)] (d) Account Agreement - Within 15 [calendar] days after a customer's account has been approved for options [transactions] trading, a member shall obtain from the customer a written agreement that the customer is aware of and agrees to be bound by the rules of the Corporation applicable to the trading of option contracts and, if he desires to engage in transactions in options issued by the Options Clearing Corporation, that the customer has received a copy of the current prospectus and that he is aware of and agrees to be bound by the rules of the Options Clearing Corporation. In addition, the customer should indicate on such written agreement that he is aware of and agrees not to violate the position limits established pursuant to Section 3 and the exercise limits established pursuant to Section 4 of this Appendix E. (May 15, 1980)

• • • Interpretation of the Board of Governors

[In approving customers' accounts for options trading, each member should consider employing a separate option account approval form for option customers in conjunction with, or in the case of established accounts, as a supplement to the standard new account approval form so as to ensure the receipt of all the

required information and, in the case of established customers, that such information is correct.]

.01 In fulfilling their obligations pursuant to subsection (b) of this Section, with respect to options customers who are natural persons, members shall seek to obtain the following information at a minimum (information shall be obtained for all participants in a joint account):

1. Investment objectives (e.g., safety of principal, income, growth, trading profits, speculation);
2. Employment status (name of employer, self-employed or retired);
3. Estimated annual income from all sources;
4. Estimated net worth (exclusive of family residence);
5. Estimated liquid net worth (cash, securities, other);
6. Marital status; number of dependents;
7. Age; and,
8. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions) for options, stocks and bonds, commodities, others.

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

1. Source or sources of background and financial information (including estimates) concerning the customer;
2. Discretionary authorization agreement on file, name, relationship to customer and experience of person holding trading authority;

3. Date prospectus furnished to customer;
4. Nature and types of transactions for which account is approved (e.g., buying, covered writing, uncovered writing, spreading, discretionary transactions);
5. Name of registered representative;
6. Name of ROP approving account; date of approval; and,
7. Dates of verification of currency of account information.

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

.02 Refusal of a customer to provide any of the information called for in Interpretation .01 shall be so noted on the customer's records at the time the account is opened. Information provided shall be considered together with the other information available in determining whether and to what extent to approve the account for options trading.

.03 The requirement of subsection (c) of this Section for the initial and subsequent verification of customer background and financial information is to be satisfied by sending to the customer the information required in Items 1 through 6 of Interpretation .01 above as contained in the member's records and providing the customer with an opportunity to correct or complete the information. In all cases, absent advice from the customer to the contrary, the information will be deemed to be verified.

Section 18 - Maintenance of Records

(a) In addition to the requirements of Section 21 of the Rules of Fair Practice, every member shall maintain and keep current a separate central log, index or other file for all options-related complaints, through which these complaints can easily be identified and retrieved. The central file shall be located at the principal place of business of the member or such other principal office as shall be designated by the member. At a minimum, the central file shall include: (i) identification of complainant; (ii) date complaint was received; (iii) identification of registered representative servicing the account; (iv) a general description of the matter complained of; and, (v) a record of what action, if any, has been taken by the member with respect to the complaint. For purposes of this Section, the term "options-related complaint" shall mean any written statement by a customer or person acting on behalf of a customer alleging a grievance arising out of or in connection with options. Each options-related complaint received by a branch office of a member shall be forwarded to the office in which the separate, central file is located not later than 30 days after receipt by the branch office that is the subject of the complaint. A copy of every options-related complaint shall also be maintained at the branch office that is the subject of the complaint.

(July 15, 1980)

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

branch office servicing the customer's account and to the principal supervisory office having jurisdiction over that branch office. (August 15, 1980)

Section [18] 19 - Discretionary Accounts

(a) Authorization and Approval - No member and no person associated with a member shall exercise any discretionary power with respect to trading in option contracts in a customer's account, or accept orders for option contracts for an account from a person other than the customer, except in compliance with the provisions of Section 15 of the Rules of Fair Practice and unless:

1. the written authorization of the customer required by Section 15 shall specifically authorize options trading in the account; and,
2. the account shall have been accepted in writing by [a general partner or officer of the member who is] a Registered Options Principal[; and].
- [3. the person approving all option transactions in such account shall be a Registered Options Principal;]

[provided, however, that in the case of a branch office, discretionary orders may be approved and initialed on the day entered by the branch office manager, provided that such approval shall be subsequently approved within five (5) business days by a general partner or officer of the member who is a Registered Options Principal. The provisions of this subsection shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite number of option contracts shall be executed.]

The Senior Registered Options Principal shall review the acceptance of each discretionary account to determine that the Registered Options Principal

accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the strategies or transactions proposed, and shall maintain a record of the basis for such determination. Each discretionary order shall be approved and initialed on the day entered by the branch office manager or other Registered Options Principal, provided that if the branch office manager is not a Registered Options Principal, such approval shall be confirmed within a reasonable time by a Registered Options Principal. Every discretionary order shall be identified as discretionary on the order at the time of entry. Discretionary accounts shall receive frequent appropriate supervisory review by the Compliance Registered Options Principal. The provisions of this subsection shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite number of option contracts in a specified security shall be executed. (July 15, 1980)

(b) Record of Transactions - No change

(c) [Prohibited Transactions - No transactions shall be executed in a discretionary account which would result in an uncovered short position in option contracts or in the uncovering of any existing short position in option contracts unless the person for whom the account is maintained has specifically authorized, in writing, transactions of this nature and such transactions are effected with due regard to the provisions of Section 19 of this Appendix E.]

Options Programs - Where the discretionary account utilizes options programs involving the systematic use of one or more options strategies, the customer shall be furnished with a written explanation of the nature and risks of such programs. (August 15, 1980)

Section [19] 20 - Suitability

(a) No change

(b) [No member or person associated therewith shall effect with or for any customer any transaction whereby such customer writes, or after writing, is obligated as a writer with respect to:

- (1) a call option contract with respect to an underlying security which is not long in the customer's account with the member or which, at the time of writing, is not concurrently purchased by such customer for such account; provided, however, an account shall be deemed long an underlying security if it is long in a security immediately exchangeable or convertible, without restriction other than the payment of money, into such underlying security; or
- (2) a put option contract;

unless on the basis of information obtained by such member or person associated with such member from such customer, after reasonable and diligent inquiry, and any other information known by such member or person associated with such member, such member or person associated with such member has a reasonable basis for believing that the customer, at the time of the transaction, is capable of evaluating the additional risks in such transactions, and has the financial capability to meet reasonably foreseeable margin calls pursuant to applicable margin requirements with respect to the proposed position in such call option contract or put option contract and any related short position in the underlying security.]

No member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in



financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract. (June 16, 1980)

Section [20] 21 - Supervision of Accounts

(a) Duty to Supervise; Senior Registered Options Principal. Every member shall develop and implement a written program provid[e]ing for the diligent supervision of all of its customer accounts, and all orders in such accounts, to the extent such accounts and orders relate to options contracts, by a general partner (in the case of a partnership) or officer (in the case of a corporation) of the member who is a Registered Options Principal and who has been specifically identified to the Corporation as the member's Senior Registered Options Principal. A Senior Registered Options Principal, in meeting his responsibilities for supervision of customer accounts and orders, may delegate to qualified employees (including other Registered Options Principals) responsibility and authority for supervision and control of each branch office handling transactions in option contracts, provided that the Senior Registered Options Principal shall have overall authority and responsibility for establishing appropriate procedures of supervision and control over such employees. (June 16, 1980)

(b) Compliance Registered Options Principal. Every member shall designate and specifically identify to the Corporation a Compliance Registered Options Principal (CROP) who may be the Senior Registered Options Principal, who shall have no sales functions and who shall be responsible to review and to propose appropriate action to secure the member's compliance with securities laws and regulations and Corporation rules in respect of its options business. The CROP shall regularly furnish reports directly to the Compliance officer (if the CROP is not himself the Compliance officer) and to other senior management of

the member. The requirement that the CROP have no sales functions shall not apply to a member that has received less than \$1,000,000 in gross commissions on options business for either of the preceding two fiscal years or that currently has ten or fewer registered representatives. (August 15, 1980)

(c) Branch Offices. No branch office of a member shall transact an options business unless the principal supervisor of such branch office accepting options transactions has been qualified as a Registered Options Principal; provided that this requirement shall not apply to branch offices in which no more than three registered representatives are located, so long as the options activities of such branch offices are appropriately supervised by a Registered Options Principal. (August 15, 1980)

(d) Headquarters Review of Accounts. Each member shall maintain at the principal supervisory office having jurisdiction over the office servicing customer accounts, information to permit review of each customer's options account on a timely basis to determine (i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved; (ii) the size and frequency of options transactions; (iii) commission activity in the account; (iv) profit or loss in the account; (v) undue concentration in any options class or classes, and (vi) compliance with the provisions of Regulation T of the Federal Reserve Board. (August 15, 1980)

Section [21] 22 - Violation of By-Laws and Rules of the Corporation or the Options Clearing Corporation

No change

Section [22] 23 - Stock Transfer Tax

No change

Section [23] 24 - Advertisements and Sales Literature

No change

\* \* \*

Article I, Section 2(d), Schedule C

I

REGISTRATION OF PRINCIPALS

(1) Registration Requirements - No change

(2) Categories of Principal Registration

(a) through (d) - No change

(e) Registered Options Principals

(i) Every member of the Corporation which is engaged in, or which intends to engage in transactions in put or call options with the public shall have at least one Registered Options Principal who shall have satisfied the requirements of this Section. Each such member shall also designate a Senior Registered Options Principal and a Compliance Registered Options Principal in accordance with the provisions of Section 21 of Appendix E to Section 33 of the Rules of Fair Practice and identify such persons to the Corporation. (August 15, 1980)

The remainder of this Section is unchanged.

\* \* \*

VIII

DISCIPLINARY ACTIONS

Every member shall promptly notify the Corporation in writing of any disciplinary action, including the basis therefor, taken by any national securities

exchange or association, clearing corporation, commodity futures market or government regulatory body against its associated persons, and shall similarly notify the Corporation of any disciplinary action taken by the member itself against any of its associated persons involving suspension, termination, the withholding of commissions or imposition of fines in excess of \$2,500, or any other significant limitation on activities. (June 16, 1980)

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#### Uniform Practice Code

#### Section 63 - Tendering Procedures for Exercise of Options (July 15, 1980)

(a) Exercise of Option Contracts

No change

(b) No change

(c) Allocation of Exercise Assignment Notices

(1) Each member shall establish fixed procedures for the allocation to customers of exercise notices assigned in respect of a short position in option contracts in such member's customer accounts. Such allocation shall be on a "first in, first out" [basis, on a basis of] or automated random selection basis that has been approved by the Corporation or on a manual random selection basis that has been specified by the Corporation. Each member shall inform its customers in writing of the method it uses to allocate exercise notices to its customer's accounts, explaining its manner of operation and the consequences of that system. [or another allocation method that is fair and equitable to the customers of such member; provided, however, that such method of allocation may provide that an exercise notice of block size will, to the extent possible, be allocated to a customer or customers having an open short position in options of

block size and that an exercise notice of less than block size will, to the extent possible, be allocated to a customer having a short position of less than block size; and provided further that such method of allocation may provide that a member shall allocate an exercise notice to a customer based upon the form of margin deposited by such customer if directed to do so by the Clearing Corporation. For purposes of this subsection (d), an exercise notice or a short position with respect to 25 or more units of trading of the same class of options shall be deemed to be of "block size."]

(2) Each member shall report its proposed method of allocation to the Corporation and obtain the Corporation's prior approval thereof, and no member shall change its method of allocation unless the change has been reported to and been approved by the Corporation. [Each member shall, upon the request of a customer, furnish to such customer a description of the method used by it in assigning exercise notices to the accounts of customers.] The requirements of this subsection shall not be applicable to allocation procedures submitted to and approved by another self-regulatory organization having comparable standards pertaining to methods of allocation.

[(3) When a non-clearing member clears all of its transactions, both proprietary and customer transactions, through another member in a single omnibus account, exercise notices allocated to the non-clearing member's omnibus account shall first be allocated on a fair and equitable basis between the proprietary and customer accounts of the non-clearing member and then allocated among the customer accounts in accordance with this subsection (c).]

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

(d) Delivery and Payment

No change

EFFECTIVENESS TIMETABLE\*

<u>NASD Rule</u>	<u>Number of Days Following SEC Approval</u>
I. <u>Appendix E</u>	
Section 16	180 days
Sections 17(a) and (d)	Immediately
Section 17(b) and (c)	** 30 days (60 days in the case of subsequent verification of suitability information required under Section 17(c))
Section 18(a)	60 days
Section 18(b)	90 days
Section 19(a)	60 days
Section 19(c)	90 days
Section 20(b)	30 days
Section 21(a)	30 days
Section 21(b), (c) and (d)	90 days
II. <u>Schedule C</u>	
I (Registration of Principals)	90 days
VIII (Disciplinary Actions)	30 days
III. <u>Uniform Practice Code</u>	
Section 63(c)	60 days

\* On a case-by-case basis, where circumstances warrant, members may be granted an additional period of time to comply with these rule changes. Under no circumstances, however, will the additional time granted for compliance with any rule exceed a period of six months beyond its proposed effective date.

\*\* Within 12 months following its effectiveness, Section 17(c) must be complied with in respect to accounts that were approved for options transactions prior to its effectiveness in order for those accounts to remain so approved.

# NASD

NOTICE TO MEMBERS: 80-23  
Notices to Members should be  
retained for future reference.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

June 6, 1980

## M E M O R A N D U M

TO: All NASD Members  
ATTN: Registered Options Principals  
RE: Handling Options Transactions for Public Customers

In Notice to Members No. 80-22, dated June 4, 1980, the Association announced SEC approval of a number of new options rules which were developed in response to certain recommendations of the Commission's Special Study of the Options Markets. The rules in large measure affect the manner in which members conduct an options business with the public and will, upon their effectiveness, require firms to adopt new procedures for handling customer options accounts.

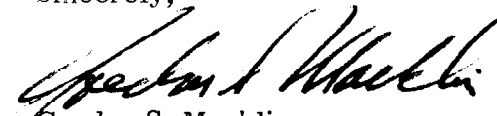
As mentioned in Notice No. 80-22, the Association, together with the six exchange members of the SRO Options Task Force, has prepared a booklet which is designed to assist members in understanding their obligations to public customers under the new options rules. A copy of that booklet entitled Handling Options Transactions for Public Customers is attached hereto for your information. This booklet supersedes the NASD's Guide to Compliance for Member Firms Conducting an Options Business which was issued in February 1979 and should be read by all registered personnel who are involved in handling or supervising a member's options activities.

The booklet may be reproduced as necessary; however, additional copies may be obtained at cost by contacting either Ms. JoAnn Scott of the NASD at (202) 833-7351 or Ms. Kathy Elliott of the Chicago Board Options Exchange at (312) 431-5721.



General questions concerning this booklet may be addressed to S. William Broka, Assistant Director, Department of Regulatory Policy and Procedures at (202) 833-7247.

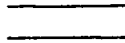
Sincerely,



Gordon S. Macklin  
President

Attachments

HANDLING OPTIONS TRANSACTIONS  
FOR PUBLIC CUSTOMERS



An educational handbook for securities firms jointly  
prepared by

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



MARCH, 1980  
1st Printing

This handbook has been jointly prepared by the seven self-regulatory organizations that have adopted rules governing their members' conduct in respect of public (non-member) customers' transactions in put and call options. The material contained in this handbook does not itself constitute the official rules of any SRO and it is intended solely as a guide for member firms to assist them in complying with applicable rules in respect of their public customers' options business. The rules of the six exchanges that are discussed in the handbook apply to firms that handle public customers' transactions in listed options; the rules of the NASD apply to activities of NASD members in both listed and over-the-counter options.

Although rules governing the handling of customers' options transactions are mostly uniform among the SROs, there are some differences among them that are not discussed in this handbook. Accordingly, this handbook should not be considered as a substitute for direct reference to the SRO rules themselves. To facilitate reference to the underlying rules, each section of this handbook is followed by a cross reference to the relevant rules of each SRO.

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## CHAPTER I

### ORGANIZATION OF SECURITIES FIRMS THAT HANDLE CUSTOMERS' OPTIONS TRANSACTIONS

#### A. Registered Persons

These rules require the registration with the SRO of designated supervisory personnel (Registered Options Principals or ROPs) and sales personnel (Registered Representatives or RRs) that have responsibility for the firm's options transactions. These persons must successfully complete a recognized examination before they are registered.

(AMEX Rules 341 and 920; CBOE Rules 9.2 and 9.3; MSE Rules 2 and 3, Art. VI; NASD Rules Sch. C., Parts I and II; NYSE Rule 720; PHLX Rule 1024a, Cir. 77-20 (8/19/77); PSE Rule X, Sec. 18(a).)

#### B. Senior ROP

Every member firm that conducts a public options business is required to designate and identify to the SRO one ROP as the firm's Senior ROP (SROP). The individual designated as the SROP must be an officer or general partner of the firm. The SROP has overall authority and responsibility for supervision of all non-member customer option accounts and related options transactions. Throughout this handbook, and particularly in Chapter IV, Surveillance and Supervision, there are examples of particular matters that are the direct responsibility of the Senior ROP. The following is a summary of the principle duties of the SROP:

1. Supervise all options transactions of customers.
2. Administer program for supervisory review of selected options accounts.
3. Assist branch office managers in supervising customers' options activities.
4. Work jointly with CROP and others in preparing advertising and sales literature concerning options.
5. Review acceptance of discretionary options accounts by ROP, and be satisfied as to reasonableness of suitability determination.

6. Review discretionary options accounts frequently.
7. Work jointly with CROP in developing and administering options training program for RRs and ROPs.

In meeting his supervisory responsibilities, the SROP may delegate the duty to review the options activities of branch offices within the firm to employees (generally ROP-qualified) under his direct control. Such delegation does not relieve the SROP of his responsibility for overall supervision and control over the firm's options activities.

(AMEX Rule 922(a); CBOE Rule 9.8(a); MSE Rule 4(b). Art. XLVIII; NASD Rule Appendix E, Sec. 21(a); NYSE Rule 722(a); PHLX Rule 1025A; PSE Rule X, Sec. 18(d) (1).)

#### C. Compliance ROP

Every member firm that conducts a public options business must designate and identify to the SRO one ROP as the firm's Compliance ROP (CROP). The CROP may not have any sales functions, unless the firm has received gross commissions on its options business (as reflected in its FOCUS Reports) of less than \$1,000,000 in either of the preceding two fiscal years, or has 10 or fewer Registered Representatives handling options accounts. The CROP and the SROP may be the same person (which for some firms would require that the SROP have no sales functions); however, the responsibilities of the two positions are different. The SROP is responsible for overall supervision of all of his firm's options activities on behalf of customers. Although the CROP may also have direct supervisory duties, he is specifically responsible for the firm's total compliance program in respect of its options activities, and he performs an audit function to determine that these activities are conducted in compliance with current applicable laws, SEC regulations and SRO rules. The CROP may, of course, delegate the performance of certain of his duties to qualified persons (generally ROP-qualified) that are under his direct supervision, but this does not relieve the CROP of responsibility for the firm's options compliance program. The CROP's activities should include frequent review of selected options customers' accounts from a compliance point of view. The CROP's review supplements the ordinary supervisory review of customers' accounts conducted by branch office managers and other senior supervisors under the supervision of the SROP, and is intended to serve as an audit of these other senior supervisory measures. In order to assure that senior manage-

ment of the firm is fully informed concerning compliance matters, the CROP must have direct access to, and must regularly furnish reports to, senior management of the firm. Specific suggestions concerning the duties of the CROP are made throughout this Handbook. The following is a summary of the CROP's principle duties:

1. Audit all aspects of firm's options compliance program.
2. Develop written program for the supervision of customers' options activities, and participate in the review of selected options accounts to assure the adequacy and proper implementation of the program.
3. Establish record-keeping procedures in compliance with SEC and SRO rules.
4. Assist branch office managers in supervising customers' options activities.
5. Establish guidelines for options advertising and sales literature, and review all such material before it is used.
6. Arrange for the review of all options soliciting material that is not advertising or sales literature either before or after use.
7. Supervise the preparation of various firm-prepared forms pertaining to options, such as the account approval form, account agreements, standard options worksheets and periodic account statements.
8. Oversee account approval procedures, including procedures for the verification of customers background and financial information.
9. Review compliance with suitability rule.
10. Review method of allocation of exercise notices.
11. Work jointly with SROP in developing and administering options training program for RRs and ROPS.

(AMEX Rule 922(b); CBOE Rule 9.8(b); MSE Rule 4(b); NASD Rule Appendix E, Sec. 21(b); NYSE Rule 722(b); PHLX Rule 1025B; PSE Rule X, Sec. 18(d) (2).)

#### D. Branch Office Managers

These rules require that the manager of every branch office that handles options transactions for public customers must be qualified as a ROP. This requirement does not apply to the manager of a branch office in which there are not more than three RRs handling options business, provided that the firm is able to demonstrate that someone who is qualified as a ROP adequately supervises all of the options activity of the branch. The ROP-qualified branch manager is responsible for the day to day supervision of all nonmember customer options activities that take place in the branch, in accordance with the firm's written supervisory procedures governing options. In meeting this responsibility, the branch manager is expected to work closely with his firm's SROP and CROP.

(AMEX Rule 922(d); CBOE Rule 9.6(b); MSE Rule 4(d); NASD Rule Appendix E, Sec. 21(c); NYSE Rule 722(d); PHLX Rule 1025D; PSE Rule X, Sec. 18(m).)

### CHAPTER II

#### APPROVING PUBLIC CUSTOMERS FOR OPTIONS TRANSACTIONS

##### A. General Procedures

These rules require that each customer must be specifically approved for options trading prior to the time that the firm accepts an options order from the customer, and they set forth the steps that must be taken in connection with that approval. The fact that a customer has been approved for general securities transactions, which may have included non-listed options transactions prior to the time that NASD rules imposed a specific approval requirement for OTC options, is not sufficient to meet the requirements of these rules. Instead, even if an account has been previously approved for other types of securities transactions, it must be re-evaluated and specifically approved for options transactions prior to accepting an option order from the customer.

It is entirely consistent with the intent of these rules for a customer to be approved only for certain types of options transactions and not for others. A customer may, for example, be approved for one or more of the following types of options transactions: (1) put transactions only, (2) call transactions only, (3) purchases and covered writing and put writing transactions. In addition, a customer may be approved for discretionary or nondiscretionary transactions. In certain cases, member firms may require minimum dollar amounts in accounts approved for particular types of options transac-



tions or may find it useful to place dollar limitations on options transactions of various types. It is suggested that the periodic review of all account activity should compare all transactions executed for the account with specific account approval to assure that the activity is consistent with the approval.

A written record of the approval of every options customer must be maintained, noting the date the account was approved, and bearing the signature of a ROP (usually the manager of the branch office in which the account is maintained) who is responsible for approving the account. In addition within 15 days after a customer's account has been approved for options, the firm must have obtained a written account agreement signed by the customer. The agreement must state that the account will be handled in accordance with applicable SRO rules and the rules of The Options Clearing Corporation and that the customer will adhere to applicable position and exercise limits. Information considered in approving an account for options transaction must be reflected in the written records of the account.

Firms may find it useful to include in the customer options account agreement a provision spelling out the obligations of a customer who writes options. Further, it may also be appropriate to include in this agreement a provision whereby the customer grants discretion limited to the closing out of open contracts shortly before the expiration of the option. Consideration should be given to including a provision whereby the customer agrees to notify the firm of any significant changes which have taken place in the customer's investment objectives and financial situation. (A request for such notification is required to be included in customer account statements; see Chapter III below.)

Finally, as evidence that the firm has complied with prospectus delivery requirements, the agreement should include the customer's acknowledgement of the receipt of a current OCC prospectus.

The requirement that all public customers must be specifically approved for options is intended to assure that the firm has exercised due diligence to determine that options transactions are appropriate for the customer in light of his investment objectives and financial situation, and that the customer has been made aware of the risks of options transactions. For these reasons, firms are required to seek to obtain specified minimum information concerning the customer's financial background and investment experience, and to provide the customer with a current OCC prospectus.

With respect to accounts in which options trading authorizations have been granted to a third person who is not an employee of the firm, including a person acting on behalf of an investment partnership or an investment club, each firm should satisfy itself of the agent's authority to act and that such authority relates to options trading. Similarly, before approving accounts of trusts, pension funds, profit sharing plans, or other fiduciaries for options trading, firms should satisfy themselves that the instruments under which the fiduciary is acting permit options trading.

(AMEX Rule 921; CBOE Rule 9.7; MSE Rule 3; NASD Rule Appendix E, Sec. 17(a), (b), and (d); NYSE Rule 721; PHLX Rule 1025; PSE Rule X, Sec. 18(b).)

#### B. Customer Background and Financial Information

The minimum background and financial information that firms must seek to obtain before approving a "natural person" customer (i.e., not a corporation or institution) for options is specified in the SRO rules cited above. Ordinarily, this information will be asked for by the RR responsible for the customer's account. Although firms may wish to obtain information in addition to the specified minimum, the following must be requested:

1. Investment objectives (e.g., safety of principal, income, growth, trading profits, speculation);
2. Employment status (name of employer, self-employed or retired);
3. Estimated annual income from all sources;
4. Estimated net worth (exclusive of family residence);
5. Estimated liquid net worth (cash, securities, other);
6. Marital status; number of dependents;
7. Age;
8. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions for options, stocks and bonds, commodities, other).

In addition to the foregoing, the customer's account records must contain the following information, if applicable:

- a. Source or sources of background and financial information, including the basis of any estimates made by the firm;
- b. If the customer has granted discretionary trading authority to any person, a written agreement must be on file and the account records must show the name, relationship to customer and experience of the person holding discretionary trading authority;
- c. The date the OCC prospectus was furnished to the customer.
- d. The nature and types of transactions for which the account is approved (e.g., buying, covered writing, uncovered writing, spreading, and whether the account is discretionary);
- e. Name of Registered Representative handling the account;
- f. Name of ROP approving account; date of approval;
- g. Dates of verification of currency of account information (see below);

Since a written record of customer background and financial information must be maintained, and in order to assure that all of the required information is asked for, firms should prepare uniform account information and approval forms to be used by all branch offices within the firm. The forms should provide a space to indicate if a customer refuses to provide any of the required information.

Firm-wide account approval forms should be designed by or under the supervision of each firm's CROP. It is the responsibility of the CROP to review the firm's account approval procedures to see that the forms are being properly used, and that the information provided, together with other information available, is being considered in determining whether and to what extent customers should be approved for options transactions.

(AMEX Rule 921(b); CBOE Rule 9.7(b); Interp. 9.7.01 and .02; MSE Rule 3(b); NASD Rule Appendix E, Sec. 17, Interp. .01; NYSE Rule 721(b), Supp. Mat. .10 and .20; PHLX Rule 1024ii and Commentary .01; PSE Rule X, Sec. 18(b) (4).)

C. Verification of Customer Background and Financial Information

These rules require that the minimum required background and financial information that has been obtained by a firm concerning a new customer that is a natural person and that serves as the basis for approving the customer for options trading must be sent to the customer for verification within fifteen days after the customer has been approved for options, and the customer must be given an opportunity to correct or complete the information. However, if the firm designs its account agreement documents so that the information on file has been received in writing directly from the customer, then the information need not be resubmitted to the customer for verification. (The background and financial information received from the customer must actually be set forth in the account agreement document at the time it is signed by the customer in order to avoid the requirement for subsequent resubmission of the information to the customer.) Additionally, if a firm becomes aware of any material change in a customer's financial situation, a copy of the background and financial information on file concerning the customer must be sent to the customer for updating within fifteen days after the firm becomes aware of such change. Whenever information is sent to a customer, absent advice from the customer to the contrary the firm may consider the information in its file to be correct.

(AMEX Rule 921(c); CBOE Rule 9.7(c) and Interp. 9.7.03; MSE Rule 3(c), Interp. .03, Art. XLVIII; NASD Rule Appendix E, Sec. 17(c); NYSE Rule 721(c), Supp. Mat. .30; PHLX Rule 1024Biii, and Commentary .03; PSE Rule X, Sec. 18(b) (4).)

D. Prospectus Delivery

Put and call options issued by OCC (the only options listed on any of the exchanges) are registered under the Securities Act of 1933 and, therefore, the prospectus delivery requirements of the 1933 Act are fully applicable to the offer and sale to customers of these options. Moreover, under SRO rules, prospectus delivery requirements apply to all options customers -- both buyers and writers. Under these rules,

customer must be furnished with a current prospectus of the Options Clearing Corporation, either before or at the time his account is approved for options transactions. Once a customer has been approved for options trading and has been furnished with the then current prospectus, thereafter each revised prospectus or prospectus supplement must be furnished to him not later than the time of delivery of the confirmation of his first options transaction following the availability of the revised prospectus or supplement. To avoid the often complicated problem of determining which customers have received which edition of the prospectus, some firms follow the practice of sending each new prospectus or supplement to every options customer as soon as it is available without waiting for the customer to engage in an options transaction.

Members should develop procedures which can be relied upon to evidence that an OCC prospectus has been delivered to each new options customer. Three methods are commonly used by member firms to evidence compliance with this rule. First, a firm may request each customer to sign, date and return a receipt for the prospectus; second, a firm may include a clause in the options account agreement to the effect that a prospectus has been furnished; or third, a firm may choose to mail all customers the prospectus from the firm headquarters, where a detailed and specific mailing list is maintained. Any of the above methods would be acceptable provided that it demonstrates that the prospectus was furnished at or prior to the time the customer's account was approved for options transactions. Similar methods should be used to evidence the delivery of subsequent revised prospectuses and prospectus supplements as required under SRO rules.

Many firms hold options seminars in their communities to generate interest in options. It is appropriate under SRO rules to deliver to each participant a current prospectus at the time such a seminar is held (a prospectus is required to be delivered if written materials are distributed at the seminar). This practice may also satisfy prospectus delivery requirements under the 1933 Act and SRO rules. However, the firm must be able to demonstrate satisfactorily that all persons attending such seminars received the then-current prospectus if it subsequently approves such persons for options trading. For example, providing a list of persons who attended a conference or seminar, without verification of actual delivery of an OCC prospectus to persons who attended, is not proof that the prospectus delivery requirements were satisfied.

The term "then-current prospectus" is defined as the OCC prospectus which is most current, including the most

recent supplement, if any, thereto. The methods used to comply with the prospectus delivery requirements should be detailed in the firm's supervisory procedures.

(AMEX Rule 921(c); CBOE Rules 9.7(e) and 9.15; MSE Rule 3(e); NASD Rule Appendix E, Sec. 12; NYSE Rules 721(e) and 726; PHLX Rules 1024 and V and Rule 1029; PSE Rule X, Sec. 18(g).)

### CHAPTER III

#### HANDLING CUSTOMERS' OPTIONS TRANSACTIONS

##### A. Suitability of Recommendations

In general, the suitability rules of the SRO's provide that any time a person at a member firm recommends an option transaction to a customer, he must have reasonable grounds for believing that the recommended transaction is not unsuitable for the customer.

Without limiting this general requirement that applies to all recommended options transactions, these rules also provide that no recommendation of an opening transaction in any option contract may be made unless 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 the recommended transactions, and is financially able to bear the risks of the recommended position in the option contract. In order to supervise compliance with these rules, it may be useful to mark order tickets "Unsolicited" or "Solicited" or "Recommended" or "Not Recommended," depending upon the terminology used by the firm.

Determinations of suitability must be based upon information obtained in response to the inquiry of the customer concerning his investment objectives and financial situation, and other information actually known by the person making the recommendation.

Since the risks involved in the purchase of options depend upon such factors as the relationship between the option's exercise price and the market price of the underlying stock, the time period remaining until the option expires, and price volatility and other characteristics of the underlying stock, such factors should be considered and, where appropriate, brought to the attention of the customer in connection with making a recommendation. Certain of the exchanges have prepared pamphlets detailing the price movement

over the last several years by calendar quarters for all underlying securities that are the subject of options traded on those exchanges.

Although these rules relate to recommended transactions only, member firms may have their own standards of suitability concerning transactions handled on an unsolicited basis.

(AMEX Rule 923; CBOE Rule 9.9; MSE Rule 5; NASD Rule Appendix E, Sec. 20; NYSE Rule 723; PHLX Rule 1026; PSE Rule X, Sec. 18(c).)

#### B. Communications to Customers

These rules and interpretations present specific standards governing all forms of communications to customers related to options. Included are advertisements, sales literature, options strategy worksheets, descriptions of options programs, presentations at firm-sponsored options seminars, and all other options-related communications directed to customers or the public. Because of the importance of the matters covered in these rules and interpretations, the SROs have jointly prepared a separate publication called "Guidelines for Options Communications" that presents an in-depth discussion of the entire subject. All persons who are responsible for preparing or reviewing options materials that firms make available to their customers should be thoroughly familiar with this publication and with the relevant SRO rules and interpretations. Because of the availability of a separate publication on this subject, this handbook presents only a brief summary of the basic principles applicable to options communications.

All options communications to customers must be balanced, truthful and in good taste. This means not only that every statement contained in any such communication must be accurate, but also that there must not be any omission of material relevant facts. For example, whenever statements are made concerning the uses or benefits of options, equal emphasis must be given to a discussion of the risks involved. Confusing, ambiguous or "fine-print" hedge clauses and disclaimers should be avoided.

Special care must be taken whenever forecasts or projections are included in sales literature. It is important that any such forecasts or projections be clearly identified as such. All assumptions, risks and costs must be clearly stated. Similarly, where reference is made to past performance or past recommendations, it must be stated that

these are not necessarily indicative of future performance. Statements of past performance must be "balanced" (i.e., they must include all relevant past performances, and not just that which was successful) and they must relate to universes that reasonably support the conclusions intended to be drawn. At a minimum, such statements must cover at least the most recent 12 months. Past performances and recommendations must be that of the firm (e.g., the firm's research department), and not simply of an individual within the firm, in order to constitute an acceptable "universe." Whenever a particular options program is described, there must be a description of its past history, or, if none is available, a statement to the effect that the program is a new and unproven one. In either case, there must be full disclosure of the underlying assumptions of the program.

SRO rules require that all advertisements and sales literature must be approved in advance by the CROP or his designee. Included among the documents that must be so approved are standard forms of options worksheets used by member firms (although each completed worksheet need not be separately approved). In addition to approval within the firm, every advertisement pertaining to options that is prepared by a member firm must be submitted to one of the SROs for advance approval or review at least ten days prior to its first use. Soliciting material not falling within the definitions of advertisements and sales literature must also be reviewed by a supervisor within the firm, but this review may occur either before or after use.

No written material concerning options may be given to any person unless the person has previously or is contemporaneously furnished with a copy of the OCC prospectus. The only exception to this requirement is for limited "tombstone" advertisements permitted by SEC Rule 134.

To assist in understanding the different requirements that apply to different types of communications, the following outline of these requirements has been prepared (for complete information, reference should be made to the SRO rules themselves and to the "Guidelines for Options Communications"):

- A. All Communications (Oral and Written) Concerning Options.
  1. Must not contain any false statements or omit any material facts.



2. Must not contain promises of specific results or exaggerated, unwarranted or unreasonable claims, opinions or forecasts.
3. Must not contain illegible, confusing or ambiguous hedge clauses or disclaimers.
4. Must meet general standards of good taste.
5. Must comply with the prospectus delivery requirements of the Securities Act of 1933.

B. Written Communications Concerning Options.

1. Must balance statements that describe potential opportunities and advantages with appropriate references to the corresponding risks.
2. Should not suggest that options are suitable for all investors nor that a secondary market for options will always be available.

C. Advertisements and Sales Literature.

1. Must be approved in advance by CROP.
2. Copies must be retained for 3 years by the firm using such material.
3. Must reflect the special risks and complexities of options transactions.
4. Must include a warning to the effect that options are not for everyone.

D. Recommendations or Past or Projected Performance Figures.

1. Not permitted in any advertisement.
2. Permitted in sales literature other than advertisements, provided that such literature meets specific requirements that include the following:

- a. The sales literature must state that supporting documentation for any claims, comparisons, recommendations or other data will be supplied upon request.
- b. Projections must disclose all relevant costs as well as all material assumptions made.
- c. Where annualized rates of return are used, they must not be based upon any less than a 60 day experience, and it must be stated that such rates might be obtained only if the parameters described can be duplicated, of which there can be no certainty.
- d. Any references to the performance of past recommendations or of actual transactions must be based upon firm-wide experience.
- e. Must be balanced and confined to an identifiable "universe" that conveys at least the most recent twelve-month period.
- f. Must include all back-up data, unless reference is to summarized or averaged records only, in which case there must be a statement that the complete record will be provided upon request.

E. Options Worksheets.

1. Come within the definition of "sales literature" and must comply with all of the requirements applicable to sales literature.
2. Standard options worksheets may be adopted only on a firm-wide basis.
3. Where standard options worksheets have been adopted, individual Registered Representatives may not use non-standard worksheets.

(AMEX Rule 991; CBOE Rule 9.21, and Interp. 9.21.01, .02 and .03; MSE Rule 3, Interp. .01, .02, Art. XLVIII; NASD Rule Appendix E, Sec. 37; NYSE Rule 791, Supp. Mat. .10, .20 and .30; PHLX Rule 1049 and Commentary .01, .02 and .03; PSE Rule VI, Sec. 35.)

### C. Discretionary Accounts

In order for a member organization to exercise discretionary power in a customer's account for options:

1. The member must obtain prior written authorization from the customer;
2. The customer's account must be accepted in writing by a ROP on the basis of the customer's suitability for the kinds of options transactions intended to be engaged in.
3. The ROP's acceptance of the account must be reviewed by the SROP or his designee, who must be satisfied as to the reasonableness of the ROP's suitability determination. A written record of the basis of the SROP review must be maintained.
4. Each discretionary order must be approved and initialed on the day entered by the manager of the branch office in which the account is maintained. Ordinarily, the branch office manager will be ROP-qualified; if he is not, his approval must be confirmed within a reasonable time by a ROP;
5. Each discretionary transaction must be identified as such on the order at the time of entry;
6. All discretionary accounts must receive frequent supervisory review by the firm's CROP.

In accordance with the foregoing requirements, discretionary authority may be granted on a limited basis when appropriate. For example, discretionary power may be limited to closing transactions or exercising existing in-the-money long positions under stated circumstances. Discretion may also be limited to particular types of options (i.e., puts or calls), or to particular types of strategies (e.g., covered call writing or buying puts to protect long stock positions).

A special requirement applies to those discretionary accounts that involve "options programs." This refers to those accounts in which one or more specific option strategies

are used on a systematic basis. For example, an options program might consist of investing a relatively small percentage of the amount in the account in the purchase of options, while investing the remainder in Treasury Bills. Another options program might involve writing call options against an existing stock position. Whenever these or any other options strategies are intended to be systematically utilized in a discretionary account, the customer must be furnished with a written explanation of the proposed strategies, noting the purposes and risks of the program. In some cases, existing literature prepared by one of the SROs may be adequate for this purpose, while in other cases, a special explanation may have to be prepared. In any case, all such written material must comply with SRO requirements pertaining to communications to customers, as described above.

The acceptance of every discretionary account must be reviewed by the SROP or another qualified senior supervisor to whom the SROP has delegated this function. Ordinarily, the person to whom this function is delegated should be ROP qualified. However, it would not be appropriate to delegate the senior review to the same ROP that initially accepted the discretionary account. Delegation of the SROP's duties in this regard does not relieve him of the responsibility for the adequacy of the review of the acceptance of discretionary accounts.

The review of each discretionary order and the frequent supervisory review of each discretionary account as a whole are intended to assure that the account is being handled in accordance with applicable standards of suitability. Apart from the need to avoid individual transactions that are unsuitable, the rules applicable to discretionary accounts also prohibit engaging in transactions that may be suitable when examined individually, but that taken as a whole are excessive in size or frequency in view of the financial resources and character of the account. The supervisory review of discretionary accounts should take place with sufficient frequency, depending in part upon the level of activity in the account, so as to be able to detect with reasonable promptness any departure from these suitability requirements or to detect any other pattern of trading that is incompatible with the limited purposes or investment objectives for which the account was approved.

Because of the special surveillance requirements presented by discretionary accounts, special record-keeping requirements apply to these accounts. There must be a written record of the approval of every discretionary account by a ROP and of the SROP's review of that approval. In addition, firms

must retain a copy of every executed options order for a discretionary account or must otherwise maintain a written record of each discretionary options transaction containing the identification of the customer, the designation of the options series, the number of contracts, the premium, and the date and time of the transaction.

(AMEX Rule 924; CBOE Rule 9.10; MSE Rule 6, Art. XLVIII; NASD Rule Appendix E, Sec. 19; NYSE Rule 724; PHLX Rule 1027; PSE Rule X, Sec. 18(e).)

#### D. Statements of Accounts

Every member firm is required to send to its options customers statements of account on at least a quarterly basis if the account has a money or securities position, and at least monthly if there has been an entry in the account during the preceding month. Statements of account must show security and money positions, entries, interest charges and any special charges that have been assessed against such account during the period covered by the statement; provided, however, that such charges need not be specifically delineated on the statement if they are otherwise accounted for on the statement and have been itemized on transaction confirmations. With respect to options customers having a general (margin) account, the statement must also provide the mark-to-market price and market value of each option position and other security position in the account, the total market value of all positions in the account, the outstanding debit balance in the account and the general (margin) account equity. If aggregate commissions paid are not set forth on the account statement, there must be a statement to the effect that information with respect to commissions and other charges incurred in connection with the execution of option transactions has been included in confirmations of these transactions previously furnished to the customer, and that a summary of this information will be made available to the customer promptly upon request.

In addition to the foregoing, in order to assist member firms in maintaining current background and financial information concerning all options customers, account statements must bear a legend requesting customers to promptly advise the firm of any material change in the customer's investment objectives or financial situation.

(AMEX Rule 930; CBOE Rule 9.12; MSE Rule 11; NASD Rule Appendix E, Sec. 16; NYSE Rule 730; PHLX Rule 1032; PSE Rule X, Sec. 18(j).)

#### E. Allocation of Exercise Notices to Customers

These rules are intended to assure that the methods used by firms to allocate exercise notices to short options positions in individual customer accounts are fair and nondiscriminatory. The rules require that allocation be made either by an approved method of random selection or by utilizing a "first in, first out" method. Each firm's CROP should review the method of allocation used at his firm to be certain that it conforms to the requirements of these rules.

Once a firm has selected a method of allocation, it must inform all of its options customers, in writing, of what that method is and what, if any, are the consequences to customers of the method selected. For new options customers, this information should be sent together with the OCC prospectus at the time the account is first approved for options.

Firms are required to retain for at least three years sufficient records and work papers to document precisely how exercise notice allocation is handled. This will enable the allocation procedures of firms to be audited as a part of routine SRO examinations.

(AMEX Rule 981; CBOE Rule 11.2; MSE Rule 2; NASD Rule Uniform Practice Code, Sec. 63(c); NYSE Rule 781; PHLX Rule 1043; PSE Rule VI, Sec. 31.)

### CHAPTER IV

#### SURVEILLANCE AND SUPERVISION

##### A. Maintenance of Customers' Account Records

In order to conduct an effective program of customer account supervision, firms must maintain complete records concerning customer accounts and transactions, and these records must be readily available to persons who perform supervisory functions. Since account supervision is the responsibility of persons at a firm's head office (or other principal supervisory office) as well as the branch office, SRO rules require that sufficient information to permit the timely review of the customers' options transactions must be maintained at the principal supervisory office having jurisdiction over the branch servicing the account. This is, of course, in addition to the set of customer records maintained at the branch office. In order to satisfy this requirement, firms must maintain at the principal supervisory office customer account

records that will permit senior supervisors to review the size and frequency of purchase transactions, the amount of commissions generated in the account, the profit or loss status of the account, whether there is undue concentration in any options classes, whether applicable margin rules have been complied with and whether applicable suitability standards have been adhered to.

In addition to the foregoing general requirement concerning the maintenance of customer account records, SRO rules specify the following minimum records that must be maintained at both the branch office servicing the account and at the principal supervisory office: copies of all background and financial information concerning customers (e.g., completed new account forms, option approval agreements, and any special option suitability documents), and copies of customer account statements for the most recent six-month period. Other records that may be useful in supervising customer accounts, such as account records that are more than six months old, need not be physically located at both the branch office and the principal supervisory office, but must be maintained so as to be easily accessible to supervisory persons at both locations.

(AMEX Rule 922(c) and (d); CBOE Rule 9.8(c); MSE Rule 4(c); NASD Rule Appendix E, Secs. 18 and 21(d); NYSE Rule 722(c), Supp. Mat. .20; PHLX Rule 1025; PSE Rule X, Sec. 18(d).)

#### B. Procedures for Senior Supervision of Customers' Accounts

SRO rules require firms to develop and implement written programs for the review of their options accounts. These programs should not only require that options accounts be reviewed by the manager or other ROP at the branch office servicing the account, but also that selected options accounts be reviewed on a regular periodic basis at the appropriate principal supervisory office, under the overall direction of the SROP. Although firms should select some of the accounts to be reviewed on a random spot-check basis, most of the accounts to be reviewed should be selected by identifying particular trading characteristics that, while not necessarily improper in themselves, suggest the need for special scrutiny.

There are set forth below examples of the kinds of characteristics that firms might utilize in identifying the particular accounts to be selected for review at the senior supervisory level. In adapting these examples for their own use, firms should use the examples as guidelines, giving con-

sideration to the particular characteristics of their customers' options trading activities, and whether automated or manual screening procedures are available within the firm. Parameters that are only generally referred to in the examples should be set at levels that can reasonably be expected to identify those options accounts that have a higher probability of evidencing possible sales abuses.

The examples set forth below should not be viewed as the only acceptable criteria, and firms have considerable flexibility in establishing their own criteria for determining which accounts receive senior supervisory review. However, it must be emphasized that a plan for the regular, periodic (at least monthly) review of selected options accounts at a senior supervisory level is required to be included in every firm's written description of its options compliance program. In those instances where a firm's plan does not include criteria comparable to those set forth below, the firm must be prepared to justify the adequacy of its plan in light of the nature of its customers' options activities. SROs will review these plans as a part of their regular examination of member firms, and will consider the absence or inadequacy of such a plan to be a material failure to comply with the requirements of the rules governing account supervision.

The following are examples of the kinds of criteria that should be considered by member firms in developing programs concerning the selection of accounts for senior supervisory review. Firms are encouraged to consider utilizing criteria in addition to those suggested, where they believe that the result would be to enhance account supervision. Although the SRO rules to which the criteria are related apply only to the options activity in customers' accounts, firms carrying accounts in which both options and non-options activities are conducted may choose to apply these criteria to all securities activities in the accounts.

With respect to margin accounts the following tests are suggested:

- A. In excess of a stated percentage increase in the debit balance in the account during the preceding month.
- B. A decrease in total equity that has exceeded a stated percentage over the preceding one, three and six months (apart from decreases due to cash withdrawals and the like).
- C. Total commissions for one month that exceed a stated percentage of account equity. This test should be applied only to accounts having



equity above a stated level in order to avoid flagging very small accounts in which any commissions would necessarily be a high percentage of equity.

Although the criteria suggested above may not be useful for those cash accounts in which options transactions take place, cash accounts may be identified for senior supervisory review based upon such factors as whether the aggregate number of options transactions effected in an account during one month, or the total commissions generated by an account during one month, exceed stated levels.

Consideration should be given to developing additional tests that will identify the need for special review of particular accounts. These tests may relate to unusual patterns of trading, large or frequent margin calls, or other signs of apparent increase in the risk exposure of accounts. In establishing specific parameters for purposes of account selection, firms may find it useful to refer to the cases cited in Chapter V of the Report of the Options Study for extreme examples of the kinds of sales abuses that an adequate program of supervisory review should be designed to detect.

Once an account has been selected for review, it should be thoroughly examined, and any problems uncovered should be the subject of special investigation. The disposition of all such investigations should be fully documented and maintained in a separate file at the firm for review during the next regular SRO examination of the firm. Information concerning accounts selected for review should also be made available to the managers of the branch offices handling the accounts.

Each firm's supervisory procedures governing customer account review must be in writing, and should specify the manner in which individual accounts are reviewed, the frequency of such reviews, and where the responsibility for each stage in the review process lies within the firm's structure.

(AMEX Rule 922(a), (c) and (d); CBOE Rule 9.8(c), Interp. .02 and .03; MSE Rule 4, Art. XLVIII; NASD Rule Appendix E, Sec. 21; NYSE Rule 722(a), Supp. Mat. .20; PHLX Rule 1025, Commentary .02 and .03; PSE Rule X, Sec. 18(d)(4).)

### C. Training of Personnel

Every firm is required to insure that those of its employees (ROPs and RRs) that are involved in the handling of

customers' options transactions are properly trained. In order to fulfill this obligation, firms may find it necessary to establish an options training program. However, SRO rules neither prescribe the adoption of a formal training program nor do they specify the specific elements that must be included in any such program. Instead, each firm's training methods should be designed in light of the characteristics of the firm (e.g., size, structure, internal organization, amount and nature of options business, level of experience of personnel).

Firm training procedures should be designed not only for persons who are new to options, but also for the benefit of experienced persons. Training should be available to all persons within a firm that are responsible for options matters, and not just to persons in the head office or in the major branch offices. Because training is so closely related to a firm's overall program for the supervision of its options activities, it should be the responsibility of both the SROP and the CROP.

Training of ROPs and RRs starts with the requirement that these persons must successfully complete an examination in connection with their registration. However, the successful completion of these entry level examinations marks only the beginning of the educational process of these persons. Other elements that are important for the continuing education of options-qualified personnel include the following:

1. Written Materials. All notices, bulletins and circulars pertaining to options that are issued by SROs and by the SEC should be made available to all options personnel within the firm. Since these materials are ordinarily initially received by the SROP in the firm's head office, each firm should establish procedures for promptly disseminating them to all branch offices that handle options accounts. In addition, copies of handbooks, pamphlets describing particular options strategies, the OCC prospectus, and similar material prepared by SROs should also be sent to the branch offices.

There has also developed in recent years a considerable body of literature on options. Firms should consider establishing a library of selected publications on options, which could then be made available to interested persons within the firm. Notice should be given of all new additions to the library.

2. Formal Instruction. Formal instruction may be an appropriate method of options training for certain firms. Such instruction may take the form of live classroom lectures or filmed or televised presentations. Alternatively, some firms may choose to send persons to courses of instruction offered by independent educational institutions.
  
3. Retesting. In addition to the entry-level examinations that are required of all registered persons, firms should consider retesting those persons whom they judge to be deficient in knowledge of how to handle customers' options accounts either through involvement in improper conduct, a high incidence of customer complaints or other indications of a lack of understanding of options. Retesting should be conducted in the same manner as for entry-level testing. Prior to being retested, persons selected for retesting should complete a program of special instruction designed to remedy their perceived deficiencies. These persons should ordinarily be precluded from handling customers' accounts until they have completed the special instruction program and have passed the required tests.

(AMEX Rules 341 and 920; CBOE Rules 9.2 and 9.3; MSE Rules Art. XLVIII and Rule 3 of Art. VI; NYSE Rules 720 and 345.15; PHLX Rules 1024 and 1025; PSE Rules X, Sec. 18(a) and VI, Secs. 14 and 15.)

# NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

June 6, 1980

TO: All NASD Members

RE: Mister Discount Stockbrokers, Inc.  
327 S. La Salle Street  
Chicago, Illinois 60604

ATTN: Operations Officer, Cashier, Fail-Control Department

On Tuesday, June 3, 1980 the United States District Court for the Northern District of Illinois appointed a SIPC trustee for the above captioned firm. Members may use the "immediate close-out" procedures as provided in Section 59(i) of the NASD's Uniform Practice Code to close-out open OTC contracts. Also, MSRB Rule G-12(h)(iv) provides that members may use the above procedures to close-out transactions in municipal securities.

Questions regarding the firm should be directed to:

SIPC Trustee

Robert E. Ginsberg, Esquire  
c/o Schwartz, Cooper, Kolb & Gaynor  
Suite 2222  
33 North La Salle Street  
Chicago, Illinois 60602  
Telephone: (312) 726-0845

# NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

June 13, 1980

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

RE: Holiday Trade Date - Settlement Date Schedule

Securities markets and the NASDAQ System will be closed on Friday, July 4, 1980, in observance of Independence Day. "Regular-Way" transactions made on the business days immediately preceding that day will be subject to the following schedule.

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

<u>Trade Date</u>	<u>Settlement Date</u>	<u>*Regulation T Date</u>
June 26	July 3	July 8
27	7	9
30	8	10
July 1	9	11
2	10	14
3	11	15
4	Independence Day	---
7	14	16

The above settlement dates should be used by brokers, dealers and municipal securities dealers for purposes of clearing and

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

settling transactions pursuant to the Association's Uniform Practice Code and Municipal Securities Rulemaking Board Rule G-12 on Uniform Practice.

Questions concerning the application of these settlement dates to a particular situation should be directed to the Uniform Practice Department of the NASD at (212) 938-1177.

Sincerely,



Gordon S. Macklin  
President

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

FOR ATTENTION OF ACCOUNT EXECUTIVES

INSIDE QUOTATIONS  
ON NASDAQ SECURITIES:  
A MAJOR MILESTONE  
FOR THE OTC MARKET

Dear NASD Member:

June 20, 1980

Starting July 7, the NASDAQ System will release to quote vendors, for display on your Level 1 terminals, and to the wire services, for transmission to the newspapers, the inside quotations--the highest bids and the lowest asks--on the 2,700 securities now on the System. The inside quotations will replace the representative bid and ask quotations (RBAs) which are presently released and which show the median quotes of market makers in NASDAQ securities.

Please bring this to the attention of all your Account Executives, so that they may make investors aware of it.

The immediate effect of the release of inside quotations will be substantially to narrow the displayed and published spreads on NASDAQ securities. A random sampling of all NASDAQ securities indicates that 75-80% of all displayed and published spreads will be narrower once inside quotations are released.

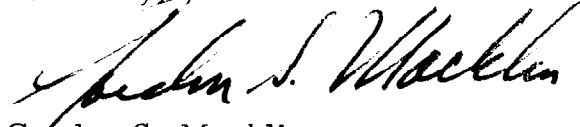
The Impact on Investors, Issuers and the Membership

It is expected that the narrower spreads will make NASDAQ securities even more attractive to investors, particularly to those investors who have been little or not at all involved in the market for NASDAQ securities. These potential investors, who have perhaps been deterred by the wider RBA spreads, may change their perceptions of NASDAQ securities when they see the spreads narrowing.

We also expect the release of inside quotations to be well received by the companies issuing NASDAQ securities. The great majority of NASDAQ companies has expressed itself strongly in favor of the change-over, as presenting their securities in a more favorable manner and as potentially broadening their shareholder lists.

Finally, the view of the NASD Board of Governors is that the release of inside quotations will, on balance, be advantageous to the membership of the Association. The improved perception of the market for NASDAQ securities, on the part of investors and issuers, should be beneficial to the professionals active in that market.

Sincerely,



Gordon S. Macklin  
President



# NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
1735 K STREET NORTHWEST • WASHINGTON D. C. 20006

19 June, 1980

TO: All NASD Members

RE: New Developments in the Association's Qualification  
Examinations Program

ATTENTION: TRAINING DIRECTORS AND REGISTRATION PERSONNEL

The purpose of this notice is to inform the membership of the following developments in the Association's qualification examinations program.

- Availability of a study outline for the Direct Participation Programs Limited Representative Qualification Examination (Test Series 22)
- Availability of a revised study outline for the Registered Options Principal Qualification Examination (Test Series 4) which incorporates the recently approved uniform options rules in the body of the outline
- Inclusion on July 1, 1980, of the recently approved uniform options rules in the test questions available for use in the ROP examination (Test Series 4)

Study Outline for the Proposed Direct Participation Programs  
Limited Representative Qualification Examination

The Association has published a Study Outline for the Direct Participation Programs Limited Representative Examination. The outlines are available from the NASD Executive Office in Washington, D. C. and any of the NASD's fourteen district offices. The charge for each outline is \$2.00.

This outline identifies the subject matter to be covered in the proposed Direct Participation Programs Limited Representative Examination (Test Series 22). The Association has filed amendments to Schedule C of its By-Laws with the Securities and Exchange Commission which, when declared effective, will authorize the introduction of this examination. When these amendments are approved by the Commission, the Association will begin implementation of the Series 22 examination. Until such time applicants for registration whose

securities activities are limited to Direct Participation Programs will continue to take the Association's Series 1 examination. A transition period will be provided for applicants holding Series 1 examination tickets to sit for this examination after the introduction of the Series 22 test.

Upon approval of the Series 22 examination by the Securities and Exchange Commission, notification will be made to members identifying the implementation date for the Direct Participation Programs Limited Representative Examination and the specific procedures to be followed during the transition from the Series 1 to the Series 22 testing programs. It is hoped that computerized administration of this examination on the Plato System will be accomplished within the third quarter of 1980.

Revised Study Outline for the Registered Options Principal  
Qualification Examination and Testing on the Uniform  
Options Rules

Beginning July 1, 1980, the industry-wide Registered Options Principals Qualification Examination will include questions on the uniform rules which were recently adopted by the self-regulatory organizations. At the same time, the weighting of the topic areas on the examination will change slightly:

	<u>Before July 1</u>	<u>On July 1</u>
1.0 Investment Strategies	26%	29%
2.0 Supervising Sales Practices	57%	54%
3.0 Trading Procedures and Business Conduct	17%	17%

To install these changes, the ROP examination will be unavailable for use from June 25 to June 30.

The study outline published for this examination has been modified to accommodate the uniform options rules. The latest outline (June 1980, Edition) may be ordered from the NASD Treasurer's Office at the NASD Executive Offices in Washington, D. C. or purchased at any of the NASD District offices for \$2.00 per copy.

Questions regarding this notice should be directed to David Uthe in the Qualifications Department at the NASD Executive Offices by telephoning (202) 833-7273.

Sincerely,



Frank J. McAuliffe  
Director of Qualifications

NOTICE TO MEMBERS: 80-28  
Notices to members should be  
retained for future reference.

# NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

19 June, 1980

TO: All NASD Members

RE: Brief Interruption in Qualification Testing

ATTENTION: TRAINING DIRECTORS AND REGISTRATION PERSONNEL

The Association will be installing software modifications in its Plato qualification examination delivery system which will necessitate suspending testing at the Control Data Learning Centers for several days. Plato testing will not be available from June 25 through June 29. Testing will resume June 30.

We regret any scheduling disruptions this may cause, but feel continuing future service necessitates these changes at this time. Questions regarding this notice may be directed to David Uthe in the Qualifications Department by telephoning (202) 833-7273.

Sincerely,



Frank J. McAuliffe

Director

Qualification Examinations Dept.

# NASD

NOTICE TO MEMBERS: 80-29  
Notices to Members should be  
retained for future reference.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.  
1735 K STREET NORTHWEST • WASHINGTON D.C. 20006

June 25, 1980

## M E M O R A N D U M

TO: All NASD Members  
ATTN: Registered Options Principals  
RE: New Rules and Procedures Affecting Allocation of Exercise  
Assignment Notices

The Effective Date of the Rules Described  
Herein is July 15, 1980

### Summary

Notice to Members No. 80-22, dated June 4, 1980, alerted members to the fact that the Securities and Exchange Commission recently approved a number of rule change proposals submitted by the Association in response to certain recommendations of the Commission's Special Study of the Options Markets. Included among these rule changes are amendments to Section 63(c) of the Association's Uniform Practice Code (UPC) which governs the allocation of exercise assignment notices received in connection with option contracts issued by the Options Clearing Corporation (OCC). The full text of those amendments is attached hereto as Exhibit A.

The amendments are designed to (1) require members to establish, within certain parameters, fixed procedures for allocating exercise notices on either an automated or manual basis utilizing a "first-in, first-out" (FIFO) or random selection method; (2) ensure that customers are advised of the method of allocation used by a member; and (3) require members to preserve for a three-year period sufficient work papers and other materials relating to the allocation of exercise assignment notices to establish the manner in which such allocation is being accomplished. The rule changes are discussed in detail in the following paragraphs.

### Choice of Allocation Methods

Section 63(c) permits each member to choose the method of allocation of exercise notices—either FIFO or random—that it wishes to use. A member must choose only one such method of allocation and must be consistent in its application of that method for all exercise assignments. A member may utilize, subject to certain limitations discussed below, either a manual or automated (computerized) system in carrying out its method of allocation.

### Approval of Allocation Procedures

Both existing Section 63(c) and the amended version of the rule require members to file their allocation procedures with the Association or another self-regulatory organization having comparable standards governing assignment of exercise notices and to obtain approval thereof prior to implementing such procedures.\* Accordingly, unless a member proposes to change its allocation procedure (e.g., from random selection to FIFO), no re-approval of an existing allocation procedure will be necessary. The procedure currently on file with the Association will be presumed to be correct.

### Manual Random Procedure

Members choosing to establish or continue to use a manual random allocation procedure, must adopt the uniform manual procedure attached hereto as Exhibit B. Members which choose to use this manual procedure must adopt it in its entirety without modification or deviation.

### Automated (Computerized) Random Procedure

Members choosing to establish or continue to use an automated (computerized) random allocation procedure must (1) adopt, without modification, the uniform automated random allocation procedure attached as Exhibit C; (2) continue their current procedure as approved by the Association or another self-regulatory organization with similar approval procedures prior to July 15, 1980; or (3) submit for approval a proposed automated random procedure.

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\* The Chicago Board Options Exchange and the American, Midwest, New York, Pacific and Philadelphia Stock Exchanges all have approval procedures similar to those adopted by the Association.

### FIFO Procedure

Members choosing to establish or continue to use a FIFO allocation procedure should be aware that they are obligated under that method to sequence short option positions by series on a trade date basis. Therefore, a member using a valid FIFO method will need to have procedures and safeguards (1) to determine when each specific option position was established; and, (2) to prevent a previously established position from being moved out of sequence due to a subsequent transaction(s) in the same option series in the same account.

### Disclosure to Customers

Section 63(c) also requires each member to disclose to its customers the method of allocation which it uses. Such disclosure may be made at the time a customer's account is approved for trading options (but not later than the time the required option agreement is executed by the customer) and, thereafter, at the time of a change of procedure. Disclosure may also be made by an addition to the option agreement, by an insert to or imprint upon a monthly or quarterly statement, by separate mailing, or by any other means by which a customer may be reasonably expected to be made aware of the member's method of allocation.

While members may adopt their own statements to comply with the new disclosure requirement, the following suggested language may also be used:

- (A) Random method of allocation — "Exercise assignment notices for option contracts are allocated among customer short positions pursuant to an automated/manual procedure which randomly selects from among all customer short option positions, including positions established on the day of assignment, those contracts which are subject to exercise. All short option positions are liable for assignment at any time. A more detailed description of our random allocation procedure is available upon request."
- (B) FIFO method of allocation — "Exercise assignment notices for option contracts are allocated among customer short positions in accordance with the date of the transaction which established the short position. Positions which were established earliest will be assigned first ("First-in, First-out"). A more detailed description of our FIFO allocation procedure is available upon request."

### Record Retention Requirements

Finally, Section 63(c) requires each member to preserve appropriate documentation relating to exercise allocation for at least three (3) years. Such documentation would include records of OCC assignments, stock records and, in

the case of random allocations, the computer-generated or other random number or, in the case of FIFO allocations, copies of customer statements or other documents showing when positions were established.

Members should provide for appropriate supervisory controls to ensure that their allocation procedures are being properly conducted.

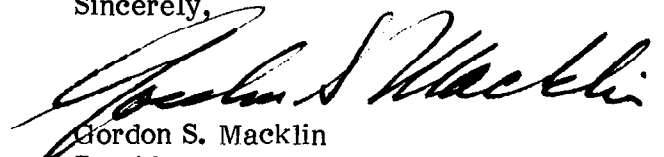
Deletions from Current Rule

Under the new rule, allocation procedures may no longer make the distinction between exercise notices of "block size" and exercise notices of less than "block size." In addition, there may be no provision for separate consideration for exercise notices based on "type of margin" deposited. Since OCC no longer uses either block size allocation or "margin type" allocation, the Association acted to rescind these provisions from its rules. Provisions in Section 63(c) concerning treatment of a non-clearing member's omnibus account have also been rescinded. The reason for this deletion is that broker-dealers who clear with an omnibus account must clear their proprietary transactions in an account separate from their customers' omnibus account, thus making the current provision unnecessary.

\* \* \* \* \*

Questions concerning this circular or the new rules discussed herein should be directed to S. William Broka, Assistant Director, Department of Regulatory Policy and Procedures, at (202) 833-7247. Questions concerning Association approval of a new or amended allocation procedure should be directed to Brian Timken, Market Surveillance Analyst, at (202) 833-7193.

Sincerely,

  
Gordon S. Macklin  
President

Attachments

Uniform Practice Code

Section 63 - Tendering Procedures for Exercise of Options

(a) Exercise of Option Contracts

No change

(b) No change

(c) Allocation of Exercise Assignment Notices

(1) Each member shall establish fixed procedures for the allocation to customers of exercise notices assigned in respect of a short position in option contracts in such member's customer accounts. Such allocation shall be on a "first in, first out" or automated random selection basis that has been approved by the Corporation or on a manual random selection basis that has been specified by the Corporation. Each member shall inform its customers in writing of the method it uses to allocate exercise notices to its customers' accounts, explaining its manner of operation and the consequences of that system.

(2) Each member shall report its proposed method of allocation to the Corporation and obtain the Corporation's prior approval thereof, and no member shall change its method of allocation unless the change has been reported to and been approved by the Corporation. The requirements of this subsection shall not be applicable to allocation procedures submitted to and approved by another self-regulatory organization having comparable standards pertaining to methods of allocation.

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

(d) Delivery and Payment

No change



Random Exercise Allocation Procedure - Manual Version

Listed below is a procedure to be used by member firms lacking an automated random exercise allocation system. The attached example should help to clarify each step.

- Step 1: a) Prepare a list of accounts and their respective short positions for each option series in which exercise notices have been received.
- b) Assign an interval of sequential numbers to each account based upon the number of contracts short.
- Step 2: a) Obtain the NYSE Consolidated Stock Volume for the previous trading day. Select the four digits in the hundred thousands, ten thousands, thousands, and hundreds positions of the volume figure.
- b) Place a decimal point to the left of the first digit to create a number ranging from .0000 to .9999. Add .0001 to this number to obtain a random number ranging from .0001 to 1.0000.
- c) Perform this step once daily, and use the same random number for all series in which exercise notices have been received.
- Step 3: a) Multiply the random number times the total number of short positions in the option series for which exercise notices have been received. The position in the interval at which the product falls (rounded up to the next higher interger) is the starting point for exercise allocation. Assignment of exercises should proceed downward from the starting point and go to the top if additional notices need to be allocated after reaching the bottom of the list.

EXAMPLE

Step 1: Short position accounts in one options series

<u>Acct. #</u>	<u>Short Positions</u>	<u>Sequential Interval</u>
105	5	1 - 5
118	3	6 - 8
227	9	9 - 17
259	7	18 - 24
291	1	25
320	35	26 - 60
388	10	61 - 70
394	30	71 - 100
410	5	101 - 105
488	2	106 - 107
	<u>107</u>	

Step 2: NYSE Volume = 27,637,500  
.6375 + .0001 = .6376

Step 3: .6376 x 107 = 68.2232  
Starting point = .6376 = random number

Notices Received (for 1 option series)

1. 4 contracts
2. 35 contracts
3. 7 contracts

Allocated as follows:

1. 2 contracts to Acct. #388
2. 30 contracts to Acct. #394
3. 5 contracts to Acct. #410
4. 2 contracts to Acct. #488
5. 5 contracts to Acct. #105
6. 2 contracts to Acct. #118

Random Exercise Allocation Procedure - Computerized Version

Listed below is a procedure to be followed by member firms who intend to use a computerized random allocation method.

Step 1: Sequencing of Accounts - All customer and firm accounts having open short positions in the option series for which exercise notices have been received must be included. Identify and list these accounts.

Step 2: Assigning Sequence Numbers - Each account in the sequence must be assigned a range of sequential numbers based on the number of contracts short in the account. This is illustrated in the following example:

<u>Account Number</u>	<u>XYZ Oct 20's # of Contracts Short</u>	<u>Sequential Numbers</u>
1	5	1 through 5
2	8	6 through 13
3	2	14 through 15
4	10	16 through 25
5	11	26 through 36
	Total	36

In this example, all accounts having a short position in XYZ Oct 20's, the series for which exercise notices have been received, are arranged in order according to account number. The number of contracts short in each account is noted and shows that there is a total of 36 contracts short in all customer and firm accounts. Account #1 is assigned a range of numbers that begin with "1" and ends with the number reflecting the total contracts short in the account which is "5". Thus the sequential numbers assigned to this account are 1 - 5. The sequential numbers for Account #2 must begin with 6 and encompass eight numbers representing the 8 contracts short in the account. This results in sequential numbers of 6 - 13 being assigned to Account #2. Account #3 is short 2 contracts and similarly is assigned sequential numbers beginning with 14 and ending with 15. This process is continued until all accounts in the sequence have been assigned unique sequential numbers. By assigning sequential numbers in this manner, the likelihood that a particular account will be selected for exercise will be proportional to its share of the total short position.

Step 3: Random Number Generation - After completing the assignment of sequential numbers, choose a random decimal number of at least five digits that is greater than 0 and less than or equal to 1.

Computer manufacturers normally provide programs to generate uniformly distributed random numbers. If your computer installation does not already have this capability, contact the computer manufacturer for assistance. If a suitable program is not available,

request that he provide a random number algorithm that can be programmed to operate on your computer.

Computer-generated random numbers ordinarily include the number 0. Since this procedure requires a decimal random number that is greater than 0 and less than or equal to 1, an adjustment must be made. This is easily accomplished by increasing the least significant digit of the computer-generated number by 1. For example, if the computer generates a five digit random number that lies in the range from .00000 to .99999, increasing the least significant digit by 1 will result in a random number that lies in the range from .00001 to 1.00000.

Step 4: Selection of a Starting Point Using the Random Number - Take a random decimal number generated over the range specified in Step 3, multiply it by the total number of contracts short in all accounts. The product, rounded to the next higher integer, will determine the starting point of the exercise assignment. In the example above there was a total of 36 contracts short in all of the accounts that had a short position in XYZ Oct. 20's. Assume that 13 contracts of XYZ Oct. 20's have been called and that the random number .48555 is selected and multiplied by 36. The result of the multiplication is 17.48, which when rounded to the next higher integer is 18. The starting point for the first contract assigned is 18, which falls in Account #4.

Step 5: Allocation of the Exercise Notice - Continuing with the example, since the exercise notice specifies that 13 contracts are to be assigned, and 18 is the starting point, 8 contracts are selected from Account #4. The next account in the sequence, Account #5, will be assigned the remaining 5 contracts. If the exercise notice related to more than 13 contracts, the assignment would continue to be absorbed by succeeding accounts in the sequence established in Step 1 until the entire assignment is absorbed. If additional notices need to be allocated after reaching the bottom of the list, continue with the first account at the top to complete the assignment.