

As can be seen from Figure II, the customer's maximum profit on this covered writing transaction, before commissions and dividends was \$175. However, after commissions are deducted, the best possible outcome for the customer would be a loss of \$2, even when projected dividends are included. Of course, should the stock decline, the customer's entire investment of \$4964 might be lost. At the same time, the lowest possible commission to the firm from the transaction would be \$139, the commission charge for putting on the position. Should the stock be sold on exercise, or liquidated at expiration, commission proceeds would increase.

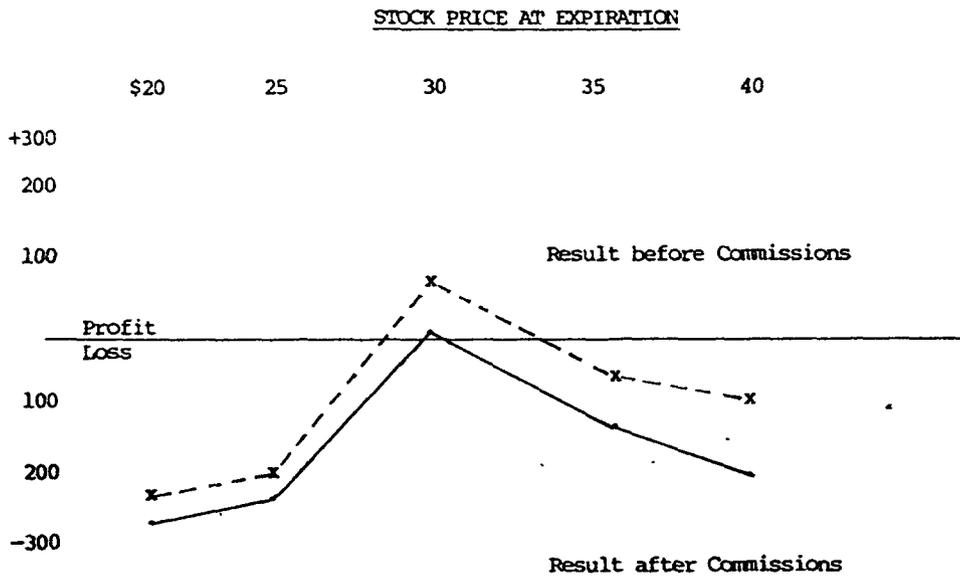
Covered writing is not the only strategy which may be uneconomic for the customer. Options spreads involve at least two, and possibly four, separate options commission charges, in addition to possibly two stock commissions. Although these commissions can have a substantial effect on the profitability of a spreading transaction, registered representatives sometimes present to customers the profit and loss potential of spreading strategies without considering commissions. Figure III depicts a "calendar" or "time" spread \* which, after commissions, was at best a break-even trade for the customer.

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\* A calendar spread involves the purchase and sale of options on the same underlying stock. The options have the same strike price but have different expiration dates.

FIGURE II

Date of Transaction: January 27, 1975  
 Strategy: Time Spread  
 Position Assumed: Buy 1 AHP OCT 30 @ 4 1/8 \$412.50 Price of Option  
 Sell 1 AHP APR 30 @ 1 7/8 (\$187.50) Proceeds of Option Sale  
 225.00  
 Cost of Transaction: \$225.00  
 Plus Commission 50.00  
 Total Cost \$275.00  
 Best Possible Outcome: Breakeven



<u>Stock Price at April Expiration</u>	<u>Result Before Commissions</u>	<u>Commissions</u>	<u>Result After Commissions</u>
\$20	(\$225)	\$ 50	(\$275)
25	( 200)	60	( 260)
30	+ 75	75	0
35	( 75)	100	( 175)
40	( 125)	100	( 225)

On July 20, 1976 a registered representative for a regional brokerage firm convinced his customer to effect the following vertical or money spread:\*

Buy 3 PRD Oct 30 @ 8-5/8	\$ 2,587.50
Sell 3 PRD Oct 35 @ 4-1/4	-1,275.00
	<u>1,312.50</u>

The best possible outcome for the customer after commission was a \$4.52 loss while the customer could have lost as much as \$1430.68. Figure IV below depicts the profit-loss potential of this "underwater trade" both before and after accounting for commissions.

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\* A vertical spread involves the purchase and sale of options on the same underlying stock. The options have the same expiration date but have different strike prices.

Figure III

Date of Transaction: July 20, 1976

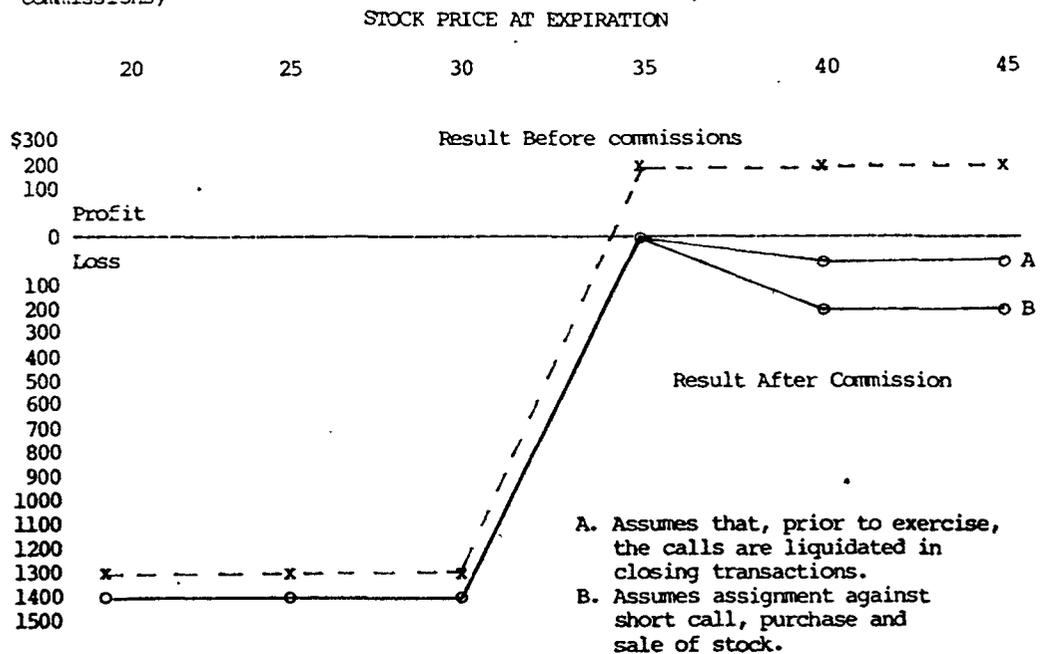
Strategy: Money Spread

Position Assumed: Buy 3 PRD Oct 30 @ 8-5/8 (\$2,587.50) Cost of Options  
 Sell 3 PRD Oct 35 @ 4-1/4 ( 1,275.00) Proceeds of Options Sale  
 1,312.50

Cost of transaction: \$1,312.50

Best Possible Outcome: -\$4.52  
 (after commissions)

Maximum Loss (Cost of transaction plus commissions) \$1430.68



Stock Price at October Expiration	Result Before Commission	Result After Commission (Assume Liquidation of Calls)	Result After Commission (Assume Short Call Assignment)
20	-1312.50	-1430.68	-1430.68
25	-1312.50	-1430.68	-1430.68
30	-1312.50	-1430.68	-1430.68
35	+187.50	-4.52	-4.52
40	+187.50	-80.60	-260.10
45	+187.50	-86.58	-285.58

b. The use of recommendation lists

Some trades which are uneconomic for customers are derived from the lists of recommended covered writing opportunities which many firms distribute to their salespersons or to customers. Frequently, these recommendation lists show the rate of return on an investment if the call is exercised, since this assumption will show the best return on investment possible in a covered writing transaction. In addition, the return figure generally presupposes a minimum purchase of at least 300 shares of stock and the sale of three calls in a customer's margin account. Comparable returns would not be possible for a smaller trade or for trades effected in a cash account since the relative commissions would be higher and the customer's deposit greater than what they would be in a margin account. For example, the following covered writing recommendations were disseminated by a large national firm to its sales staff in May 1976. The firm's recommendation list included the information in Columns I through IV. Column V, calculated by the Options Study and based on a purchase of 100 shares and the writing of one call, demonstrates the significance that commissions can have on the small investor and his choice of options strategies.

I	II	III	IV	:	V
			Rate of	:	Rate of
			return if calls	:	return if call
			exercised (300	:	exercised (100
			shares, 3 calls)	:	shares, 1 call)
<u>Option</u>	<u>Stock</u>	<u>Option</u>		:	
<u>Series</u>	<u>Price</u>	<u>Price</u>		:	
CTC Jan 15	14 1/8	13/16	19 %	:	5.7 %
MOB Nov 60	58 7/8	3 3/4	16	:	5.1
FCF Oct 15	14 7/8	2	18	:	7.5
IR Nov 25	23 7/8	1 5/8	20	:	7.2
JM Nov 30	29 7/8	2 5/8	20	:	7.2
EK Jul 110	107 1/8	5 1/8	11	:	5.8

One registered representative testified that he effected for a customer account an uneconomic trade which he derived from his firm's national recommendation list. Such a situation is not unlikely since firms do not always warn users of the lists that the recommended transactions may be only marginally profitable or even uneconomic at sizes different from those recommended by the firm.

Another disturbing aspect of some recommendation lists composed by major brokerage firms is that the recommendations, including those without adequate warnings, are sometimes made available to registered representatives through a toll-free telephone number with only an admonition to employees that the telephone number is not to be circulated outside the firm. Approximately 20 percent of the firms in the industry group sample use, or have used, an internal phone service to make periodic options recommendations available to their sales force. Most of these firms have no effective controls to prevent dissemination of the toll-free numbers of these phone services to public investors. As a result, customers may be able to use the "Dial-An-Option" features directly.

Transactions with little or no profit potential to the customer are not necessarily effected only by unscrupulous registered representatives. The Options Study believes that some customers are involved in uneconomic transactions simply because their registered representatives do not understand the transactions which they are recommending. Table VI below presents four covered call writing transactions which one registered representative actually recommended to and executed for his customers:

TABLE VI

<u>Security</u>	<u>Maximum potential profit before commissions</u>	<u>Commissions</u>	<u>Maximum potential profit after commissions</u>	<u>Capital at risk</u>
Braniff	\$270	\$179	\$91	\$2836
Coastal States	290	202	88	3841
Bally Mfg.	217	121	96	1863
Inexco	249	134	115	2332

As can be seen, each of these four transactions results in a commission benefit to the registered representative and his brokerage firm which exceeds the customer's maximum potential profit after commissions. Moreover, the customer's best outcome (after commissions are deducted) is small, particularly when compared to the capital which the customer must place at risk. These trades are particularly troublesome because they involve covered writing, a strategy widely touted as "conservative" by many registered representatives and brokerage firms.

The Options Study noted that those covered writing trades which proved to be uneconomic to the customer usually involved recommendations to purchase stock and to write in-the-money calls against it. This strategy denies the customer any profit potential from a rise in the price of the underlying stock, since it effectively limits the potential profit of the trade to the amount by which the sum of the time premium and dividends received exceeds the commission charges for the trades.

An example of such a trade was described in a complaint letter from a customer. This customer, whose investment objective was capital appreciation, was convinced by a registered representative

for a national brokerage firm to buy 200 shares of International Harvester at 27 3/4 and sell two calls with a strike price of \$25 at 3 7/8 each. The customer's maximum potential profit was \$225 (1 1/8 on each of the two calls written), plus projected dividends, less commissions. Even if the customer were not assigned an exercise notice prior to the payment of International Harvester's dividend (\$75 on 200 shares), his maximum profit (including the \$75 dividend) would be \$78.53 while his brokerage firm's commission revenue from the same trade would be \$221.47. The more likely event, an exercise prior to payment of the dividend, would deprive the customer of the \$75 dividend and result in a maximum profit to the customer of \$3.53 - a small return when compared to the investment of nearly \$5,000. This transaction is summarized below in Figure V:

FIGURE V

TRANSACTION: Buy 200 Int'l Harvester @ 27 3/4	\$5,550	Cost of Stock
Sell 2 Int'l Harvester APR 25 @ 3 7/8	( 775)	Proceeds from
	4,775	Calls

Cost to establish position: \$4775.00

Commission: 130.62

Capital at risk: 4905.62

Maximum return  
before commission  
and dividend: \$225

Maximum gain if  
calls exercised  
before dividend,  
commission deducted  
(\$221.47): \$3.53

Maximum gain if call  
not exercised before  
dividend, commission  
deducted (\$221.47): \$78.53

### 5. Conclusions and Recommendations

The Options Study has found numerous problems arising from the dual role of the registered representative as commission salesman and investment adviser. These problems include not only excessive trading in customer accounts and uneconomic trades which benefit the salesperson and his firm more than the customer, but also recommendations for options trading unsuitable for customers, use of misleading selling documents to induce customers to trade options and various misrepresentations to customers about the status of their accounts.

Earlier sections of this chapter set forth recommendations designed to improve the controls on customer suitability and to prevent the abuses of the various forms of salesperson/customer communication. Implementation of these recommendations would help provide the customer with sufficient information concerning the status of his account, commissions, and other charges, to enable him to monitor the activity in his own account. The same controls would also help firms and regulators to analyze and control customer options account activity.

However, additional controls are necessary to insure that the firm is able adequately to monitor options trading in customer accounts. Existing compliance systems, which flag accounts by using a single parameter for commissions and/or number of trades, are not adequate to meet the needs imposed by options trading. For example, existing reviews may not identify rapid or large increases in risk in an

account or may not detect irregular trading in a small account in which the activity level fails to exceed an established parameter.

Likewise, a brokerage firm's system that places total reliance on activity letters to determine whether a customer is aware of the questionable trading in his account may not alert the firm's supervisors to a problem account. Unless the customer understands the purpose of the letter, he may not give it appropriate attention or the salesperson may discourage him from returning it or otherwise responding to the firm. In addition, brokerage firms are hesitant to send candid letters to customers since the questioned trading may be acceptable to the customer.

As long as firms rely on selection criteria which do not relate the level of account activity to the equity in the account or to the customer's investment objectives, they will be unable to properly monitor the trading in customer accounts.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD  
ADOPT RULES REQUIRING THAT THE HEADQUARTERS  
OFFICE OF EACH BROKER-DEALER ACCEPTING  
OPTIONS TRANSACTIONS BY CUSTOMERS BE IN  
A POSITION TO REVIEW EACH CUSTOMER'S OPTIONS  
ACCOUNT ON A TIMELY BASIS TO DETERMINE:

- COMMISSIONS AS A PERCENTAGE OF THE ACCOUNT EQUITY;
- REALIZED AND UNREALIZED LOSSES IN THE ACCOUNT  
AS A PERCENTAGE OF THE CUSTOMER'S EQUITY;
- UNUSUAL CREDIT EXTENSIONS;
- UNUSUAL RISKS OR UNUSUAL TRADING PATTERNS  
IN A CUSTOMER'S ACCOUNT.

The Options Study found that some of the most serious trading irregularities occurred in customer accounts which were handled by a registered representative on a discretionary basis. Since many of these customers did not understand the risks involved in options trading, they could not adequately monitor their own accounts. Particularly vulnerable were customers who entrusted funds to registered representatives to be managed on a discretionary basis according to the terms of options "programs" which entailed speculative or risky options strategies. Even the additional customer disclosure information recommended earlier in this report might not provide sufficient protection for some of these customers.

Customers who grant discretion over their accounts to a registered representative depend on that registered representative to make investment decisions suitable to their investment objectives. Both the Commission and the courts have held that whenever a customer is dependent upon his broker, the broker has a special duty not to take advantage of his customer. 49/ This duty has been viewed alternatively as a fiduciary duty 50/ and as part of the broker's implied representation that he will deal fairly with his customer. 51/ A violation of this special duty is a violation of the antifraud provisions of the securities laws.

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49/ Ducker & Ducker, 6 SEC 386 (1939); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943), cert. denied, 34 U.S. 786 (1944).

50/ G. Alex Hope, 7 SEC 1082, 1083 (1940); Barthe v. Rizzo, 384 F. Supp. 1063 (S.D.N.Y. 1974).

51/ Charles Hughes & Co. v. SEC, supra note 49.

In addition, registered representatives who exercise discretion over securities accounts of customers are subject to the traditional requirements imposed by state law on those who manage the money of others, including, unless otherwise agreed, a duty to preserve the beneficiary's capital and to avoid speculation. 52/

The Options Study believes that any registered representative (or firm) who proposes to exercise discretion over an account trading options should, as a part of the obligation to deal fairly with the customer, disclose to the customer the nature and risks of any proposed trading program or strategy which is not designed specifically to preserve capital or which involves speculation. For this disclosure to be effective, the customer must understand it. Accordingly, the Options Study believes that, before a customer is allowed to participate in any discretionary options trading program, the firm and the registered representative should have reasonable grounds to believe that the customer is able to bear financially the risks of the proposed trading program and also to understand the nature of the risks involved.

Accordingly, the Options Study recommends:

(1) THE SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR RULES TO REQUIRE THAT EACH OPTIONS CUSTOMER IN WHOSE ACCOUNT DISCRETION IS TO BE EXERCISED IS PROVIDED WITH A DETAILED WRITTEN EXPLANATION OF THE NATURE AND RISKS OF THE PROGRAM AND STRATEGIES TO BE EMPLOYED IN HIS ACCOUNT; AND

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52/ Restatement (Second) of Agency § 425 (1958).

(2) THAT THE SROP OF EACH BROKERAGE FIRM PERSONALLY MAKE A DETERMINATION IN EACH CASE THAT THE DISCRETIONARY CUSTOMER UNDERSTANDS AND CAN BEAR THE RISKS OF THE OPTIONS TRADING PROGRAM OR STRATEGIES FOR WHICH IT IS PROPOSED THAT HE GRANT INVESTMENT DISCRETION TO THE FIRM OR ANY OF ITS EMPLOYEES; AND THAT THE SROP MAKE AND MAINTAIN A RECORD OF THE BASIS FOR THAT DETERMINATION.

I. EXERCISE PROBLEMS

1. Introduction

Before the availability of listed options, each put and call options constituted a contract directly between two identifiable parties, the holder (buyer) and the writer (seller). When the option holder exercised his option, the contract obligated the call writer to sell the underlying security to the option holder, or the put writer to purchase the underlying security from the option holder.

The introduction of listed options issued by the OCC, however, has severed the contractual obligations between writer and holder. In the event of exercise, the holder of a listed option looks to the OCC, rather than to a specific writer, for delivery or purchase of the underlying stock; the OCC, in turn, demands performance from an option writer who is contractually obligated to the OCC through a broker-dealer firm.

The specific writer to be exercised is selected through an allocation process. First, the OCC assigns an exercise notice to a selected broker-dealer firm which has sold, either for its own account or for a customer account, an option in the same series as the exercised option. Next, if the assignment is for a customer account, the brokerage firm re-allocates the exercise notice to one or more of its public customers according to a plan filed with and approved by the options exchanges.

When a customer who has written an option is assigned an exercise notice, he no longer can liquidate his position in the options market but must fulfill the terms of his obligation. Whether the position was uncovered or covered, he will incur commission costs.

Although the integrity of this allocation system is vital to the maintenance of investor confidence in the fairness of the options markets, the following example indicates that several weaknesses exist in the present exercise system.

In a series of trades executed in early March 1977, floor brokers for a national brokerage firm purchased enough Coca Cola May 70 calls on the American Stock Exchange to close out an existing ten contract short position in the firm's proprietary account. By mistake, however, the brokers marked the order tickets as opening rather than closing purchase transactions. As a result of this mismarking, the records of the OCC showed that the firm's account maintained a ten contract long and a ten contract short position in the Coca Cola May 70's, while the firm's record showed a flat position in these options.

On March 2, 1977, Coca Cola declared a dividend of \$.77 per share payable to holders of record on March 16, 1977. In an attempt to capture this dividend, certain holders of the May 70 Coca Cola call options exercised their options about two months before expiration. On March 10, 1977, the ex-dividend date, the OCC assigned to the same national brokerage firm's proprietary account an exercise notice for the 10 Coca Cola May

70 call options contracts reflected in the OCC records. Although this exercise notice was clearly directed to the firm's proprietary account, the firm's employees "re-allocated" the exercise assignment to the accounts of several unsuspecting public customers. Had the firm delivered its own Coca Cola stock to meet this exercise notice, it would have been forced to forego the \$770 dividend on the 1,000 Coca Cola shares delivered.

Later that day, the brokerage firm employees discovered that two of the public customer accounts to which they had "misallocated" these exercise notices had already been transferred to another brokerage firm. With the cooperation of the new brokerage firm, these employees were able, in effect, to pass along the exercise assignment notices to the already transferred customer accounts.

The unsuspecting customers delivered the Coca Cola stock as required, lost the dividend on that stock, and paid aggregate commissions of \$719.50 for the exercise transaction. The brokerage firm, on the other hand, received a \$770 dividend on the 1,000 Coca Cola shares it should have delivered from its own account in response to the exercise notice.

This misconduct was discovered by one of the exchanges only by accident and not through any organized examination or investigation process. 53/ None of the public customers who had been assigned exercise notices ever learned that he had borne the burden of a

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53/ This matter was initially discovered when two exchange employees overheard a conversation among strangers on the New York subway.

misallocation. Despite exchange rules that provide public access to exercise allocation plans devised by broker-dealer firms, customers generally have little chance to detect shortcomings in the design or irregularities in the operation of such plans.

Proper prevention and detection of abuses such as the one described above require:

- (1) an exercise allocation method fair to the public customer; and
- (2) adequate documentation and supervisory controls to assure that these allocation procedures are being followed consistently.

## 2. Allocation Plans

Exchange rules require each member firm to file with the various options exchanges its plan for allocating exercise notices to its customers and to make these plans available for review by customers. Despite the straightforward requirements imposed by these exchange rules, brokerage firms sometimes circumvent or ignore the requirements. Consequently, both the AMEX and CBOE have had to caution numerous firms for failure to submit their plans for approval or for failure to follow their declared allocation procedures once approved.

Among the allocation methods approved by the exchanges are a random selection basis, a "first-in, first-out" basis, variations of these methods to distinguish between "block-size" orders and individual orders, and other methods deemed fair and equitable to the member firm's customers. Of the industry group sample, 62 percent used variations of the

random selection allocation methods; 36 percent used "first-in, first-out" allocation methods; and 2 percent of the industry sample used other methods. There seems to be a trend throughout the industry toward random selection and away from "first-in, first-out" allocation methods. Each method has advantages and certain regulatory problems arise from each.

a. Random selection methods

Although the sophisticated sampling techniques of certain random basis allocation systems provide a high degree of objectivity, the complexity and lack of uniformity of such methods can impede firms and regulators in conducting prompt and effective audits. Reconstructing how exercise notices were allocated during even one expiration period is sometimes difficult.

Of greater concern to the Options Study, however, are the informal random basis allocation systems. A senior officer of one firm, for instance, described his firm's allocation method as the "flip of the coin" method. The employees of another firm explained how that firm used "a random draw" allocation method as follows: they created "named slips" for each short contract in a given customer's option position, pooled those slips, and then engaged in a drawing to determine the allocation of exercise notices.

The most prominent weakness of these informal exercise allocation systems is the absence of workpapers or other documentation to verify that the allocation process was accomplished in a manner fair and equitable to public customers. In addition, in several cases, brokerage firms had

no supervisory procedures which described even the informal procedures that the firm purported to follow. These circumstances provide little assurance that allocation methods will be consistently or equitably applied from one expiration date to the next.

b. "First-In, First-Out" (FiFo) systems

In a FiFo allocation system, the first customer to be assigned an exercise notice in an options series is the customer who first wrote a still-open contract in that options series. Although straight-forward FiFo systems are easily understandable and verifiable by audit, FiFo systems generally work to the disadvantage of longer term options investors who are more likely to be exercised than customers with more recently established positions.

In addition, some brokerage firms use variations of the FiFo allocation system which favor the active or large account or which are otherwise inconsistent with exchange requirements that such systems be "fair and equitable" to customers. Both the CBOE and the AMEX repeatedly have cautioned firms against the use of FiFo systems which do not assure that the customer who first writes an option will be assigned an exercise first regardless of other subsequent activity in the account. Nevertheless, several firms still use modified FiFo systems which provide that any activity in an account subsequent to the trade date automatically updates that account's "first-in" date to the date of the most recent activity.

Such a modification reduces the risk that exercise will fall upon the more active and larger account while increasing the risk of exercise for the smaller or less active account.

Exercise allocation methods must be fair and equitable to the public customer. Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD  
AMEND THEIR RULES TO REQUIRE MEMBER FIRMS  
TO PROMPTLY ADOPT A UNIFORM METHOD FOR  
THE RANDOM ALLOCATION OF EXERCISE NOTICES  
AMONG CUSTOMER ACCOUNTS.

### 3. Audit Trails

The most pervasive weakness in the process of allocating exercise notices is the lack of an audit trail, that is, of workpapers, records, or other documentation which enable supervisors and regulators to verify that an approved exercise allocation plan has been followed. Since certain firms do not maintain adequate documentation to explain the operation of their allocation methods, some supervisors express confusion about the exercise allocation procedures they are supposed to control. Other firms have no records to verify that the procedures they purport to use have, in fact, been applied.

The experience of one large regional brokerage firm demonstrates many of the weaknesses associated with this lack of an audit trail for exercises allocations. Although the compliance officer of the firm told both NASD and Commission inspectors that the firm used a FIFO method of exercise allocation, analysis of customer accounts which had been

assigned exercise notices during several expiration periods disclosed numerous departures from any known FiFo method of allocation.

In the ensuing investigation, employees of the firm gave conflicting testimony about the procedures followed by the firm in allocating exercise notices among customers. Both the firm's president and compliance officer testified that they believed the firm employed a FiFo system. The margin clerk, however, testified that his supervisors had instructed him to employ the FiFo system unless an assignment would affect one of the customers of the firm's head options trader. In that case, he was to inform the head options trader of the customer accounts having positions which could be exercised, after which he would receive a list of customer accounts designated to receive exercise notices. The margin clerk testified about the problems that arose when he initially attempted to use the FiFo method:

After I notified [the head trader] of the assignments, I proceeded to work on that method by assigning the customers the options that were first in. And apparently [the head trader] did not like the assignments as I related them to him, and spoke to [the sales manager] who in turn called my boss, who was operations manager, and I was told by my boss to go along with whatever assignments they wanted.

The firm's options trader insisted that he merely served as a conduit for information between the margin clerk and the sales manager of the firm. In contrast, the sales manager testified that he personally allocated all exercise assignments on a random basis, using an

undocumented lottery method in which he blindly selected slips of paper representing customer positions. An analysis of customer options accounts, however, revealed that certain customers consistently sustained large losses from untimely exercises while other customers consistently avoided exercise. Most of the accounts assigned exercise notices were those of long time customers with large account equity who could bear the losses resulting from exercise better than smaller accounts serviced by younger salesmen.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD  
REQUIRE MEMBER FIRMS TO KEEP SUFFICIENT  
SPECIFIC WORKPAPERS AND OTHER DOCUMENTATION  
RELATING TO ALLOCATIONS IN PROPER ORDER  
SO THAT A FIRM'S COMPLIANCE WITH THE UNIFORM  
EXERCISE ALLOCATION SYSTEM CAN BE VERIFIED  
PROMPTLY FOR AN APPROPRIATE PERIOD OF  
TIME.