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96th Congress }
1st Session }

COMMITTEE PRINT

{ Committee
Print 96-IFC3

REPORT
OF THE
SPECIAL STUDY OF THE
OPTIONS MARKETS
TO THE
SECURITIES AND EXCHANGE COMMISSION



December 22, 1978

Printed for the use of the
House Committee on Interstate and Foreign Commerce

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LETTER OF TRANSMITTAL



OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

February 15, 1979

The Honorable James Scheuer
U. S. House of Representatives
Washington, D. C. 20515

Dear Congressman Scheuer:

I am pleased to transmit herewith The Report of the Commission's staff's Special Study of the Options Markets.

Sincerely,

A handwritten signature in cursive script, appearing to read "Harold M. Williams", written over a horizontal line.

Harold M. Williams
Chairman

(III)



Special Study
of the
Options Markets

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

December 22, 1978

To the Chairman
and Members of the Securities and Exchange Commission

It is an honor to transmit to the Commission the Report of the Special Study of the Options Markets. The Report describes the findings and recommendations of the Options Study in response to the Commission's directive set forth in its public release of October 1977. */ The Commission specifically directed the Options Study to investigate and study the listed options markets to determine the ability of self-regulatory organizations, including national securities exchanges and the National Association of Securities Dealers, Inc., to carry out their regulatory responsibilities to assure that listed options trading is occurring in a manner, and in an environment, which is consistent with the maintenance of fair and orderly markets, the public interest, the protection of investors and the other objectives of the Securities Exchange Act of 1934.

In general, the Options Study found that options can provide useful alternative investment strategies to those who understand the complexities and risks of options trading. But, since regulatory inadequacies in the options markets have been found, the Options Study is making specific recommendations needed to improve the regulatory framework within which listed options trading occurs and to increase the protection of public customers.

The Report is divided into eight chapters. The Introduction includes a summary of the Options Study's conclusions and recommendations. Chapter II describes some fundamental uses of options. Chapter III describes the ways that market professionals use listed options. Chapter IV describes and evaluates the market surveillance systems of the self-regulatory organizations. Chapter V discusses options selling practices. Chapter VI analyzes the adequacy of self-regulatory organization oversight of broker-dealer firms. Chapter VII describes financial regulation in the options markets. Chapter VIII discusses certain market structure issues that proposals to initiate new options trading programs have raised.

*/ Securities Exchange Act Release No. 14056 (October 17, 1977).

VI

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

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

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

VII

The Options Study also found that in the area of oversight of broker-dealer retail activities, as well as market surveillance, there was a need for greater cooperation and sharing of information among the self-regulatory organizations to avoid present duplication of activities and to substantially improve the effectiveness of the combined regulatory efforts. In order to facilitate this cooperation, representatives of the self-regulatory organizations formed a Self-Regulatory Conference to consider ways in which to improve the coordination of their activities and to share market surveillance and other regulatory data. To be successful, this effort will require the full cooperation of the self-regulatory organizations and the support and participation of the Commission.

In general, the recommendations of the Options Study call for action by the self-regulatory organizations to improve their own procedures and those of their member firms. Placing primary responsibility on the self-regulatory organizations reflects the importance of self-regulation in the regulatory pattern of the securities industry. If the self-regulatory organizations do not act, the Options Study recommends that alternative action should be taken by the Commission through its authority over the self-regulatory organizations and through its own enforcement powers.

For the most part, the Options Study has used examples of actual abuses to demonstrate the problems which its recommendations are expected to correct. The Options Study has not generally mentioned firms or individuals by name, nor has any attempt been made to quantify the extent of the abuses. The goal of the Options Study has been to recommend improvements where regulatory lapses have permitted significant abuses to occur or where additional abuses could occur if corrections are not made. While some recommendations may increase costs to the self-regulatory organizations and broker-dealers, the Options Study has made every effort to develop the least costly solutions and has sought means to reduce current duplicative regulatory efforts in some areas so as to offset increased efforts required in other areas.

Throughout its work, the Options Study has been aided by the cooperation of the self-regulatory organizations, the Securities Industry Association and broker-dealer firms. In many instances, the Options Study imposed substantial extra burdens on both organizations and individuals. Without the assistance of a number of individuals who made their expertise freely available, the Options Study could not have completed its task within the time period that the Commission established. Except as otherwise noted, staff investigations were concluded by the end of August 1978, although an effort has been made to take into consideration any subsequent improvements reported by the self-regulatory organizations.

VIII

In addition, during the period of the Options Study, a number of improvements were made in the regulatory programs of the self-regulatory organizations. Some of these improvements may have been coincidental with the Options Study's work. Others, however, may have represented an acceleration of improvements that would otherwise have occurred. Unquestionably, many improvements resulted from the increased attention given to finding solutions to deficiencies by both the securities industry and the Commission during the moratorium.

While much of the Report focuses on the deficiencies that were found in the regulation of the options markets, credit must be given to the self-regulatory organizations for the regulatory and surveillance work that they have accomplished since listed options trading began in 1973. Many recommendations of the Options Study are designed to extend to all self-regulatory organizations techniques which were developed and are already employed by one or more of the self-regulatory organizations.

In view of the scope and complexity of the matters covered in the Report, the Options Study cannot be viewed as providing the definitive answers to all of the questions which need to be answered. In accordance with the Commission's directive to concentrate on the regulatory aspects of the self-regulatory organizations, the Options Study's recommendations are designed to be effective in the options markets as they currently exist. Thus, in many respects, the Options Study is merely a beginning. Its efforts should be continued as a part of a regular Commission program of oversight of the options markets. Some of the Options Study's recommendations are designed to continue this effort by developing new sources of data so that the Commission and self-regulatory organizations can examine potential problems which the Options Study could not analyze because adequate, usable data was not available.

The Options Study did not undertake a study of certain broader issues. The Options Study, for example, did not undertake its own broad economic studies of the effect of options on the trading in the underlying stocks or on the capital raising functions of the securities markets, but instead has referred to studies performed by others. As the options market matures, and as additional information becomes available, further studies will be needed. The Options Study did not attempt to compare the specialist and competing marketmaking systems used by the options exchanges. Similarly, while the Options Study has made recommendations to improve the ability of those who make markets on the floor of an exchange to use credit in their marketmaking activities on terms more favorable than public customers,

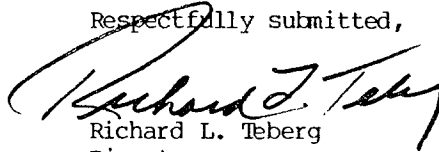
IX

it did not consider whether there should be changes in the present system of credit regulation which might make such favorable treatment unnecessary or inadvisable.

A concerted effort has been made to simplify the description of the matters covered in the Report and to avoid technical jargon and extensive references to rules and regulations and legal precedents. Unfortunately, the complexity of the subject matter has prevented us from meeting this goal consistently. The pronoun 'he,' rather than other alternatives, has been employed throughout this Report to avoid the awkward reference 'he/she'.

While the staff of the Options Study is responsible for the Report's contents, it was aided greatly by other members of the Commission's staff. It drew upon the time and resources of the various Commission Divisions in Washington and upon all of the Commission's Regional Offices. Much information, along with ideas which form the core of the Options Study's recommendations, was developed from these sources. A list of Commission staff personnel who contributed to the Options Study appears at the end of this letter under "Acknowledgments." Special mention, however, must be made concerning the extensive and continuing support of Andrew M. Klein, Sheldon Rappaport, and Kathryn B. McGrath of the Division of Market Regulation, Stanley Sporkin, Wallace L. Timmeny, Theodore A. Levine and Ira H. Pearce of the Division of Enforcement, and Ralph C. Ferrara and Robert C. Pozen of the Office of the General Counsel. The Options Study was organized and directed by Martin L. Budd until June 16, 1978, when he resigned as Director for personal reasons.

Respectfully submitted,



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Director

THE SPECIAL STUDY OF THE
OPTIONS MARKETS

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XII

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