

August 17, 1981

Bruce J. Simpson, Esq.  
Special Regulatory Advisor  
Chicago Board Options Exchange, Inc.  
LaSalle at Jackson  
Chicago, Illinois 60604

Dear Mr. Simpson:

As you are aware, the Division of Market Regulation's Office of Inspections, Examinations and Surveillance, assisted by Chicago by the Chicago Regional Office (the "staff"), conducted an oversight inspection of the Exchange's compliance programs in November, 1980. The purpose of this letter is to summarize the findings of that inspection.

The staff found that, with the exception of specific items discussed below, the Chicago Board Options Exchange, Inc. ("CBOE" or "Exchange") conducts its compliance programs adequately and effectively. In particular, the staff found that the CBOE has made a laudable commitment of examiner time and Exchange resources to the investigation of sales practice abuses, resulting in the high quality of the Exchange's sales practice examinations that we reviewed.

Nevertheless, the inspection disclosed several areas of concern. The staff's major concern involves delays in the Exchange's routine examination cycle. Of the 60 examinations scheduled for 1979, only 34 (57%) were commenced during that year. Similarly, in 1980 only 23 (66%) of the 36 routine sales practice examinations scheduled for that year had been commenced by mid-November, and 12 of those 23 examinations were still open at that time. The CBOE has not maintained an annual examination cycle either with respect to those firms allocated to the CBOE under Rule 17d-2 agreements or with respect to those firms for which it is the sole options examination authority. While the delays appear to have resulted, in part, from significant staff turnover in the Exchange's New York office, and from the CBOE's commendable commitment of substantial staff time to examinations of large wirehouses and to special examinations, the delays are, nevertheless, of great concern to us. We would therefore like you to advise us promptly as to what action you will take to assure that the Office of Member Firm Examinations will be able to adhere to an annual schedule for routine examinations.

In the Exchange's cause investigation program the staff noted two instances where the CBOE appeared to have conducted inadequate investigations and failed to present those investigations to the Business Conduct Committee ("BCC"). The staff also noted one case in which there was a significant delay in conducting an on-site cause investigation.

One of the cases in which the staff was concerned with the thoroughness of the Exchange's investigation involved the complaint of Marion Stevens against her registered representatives at E.F. Hutton & Co., Inc. (I-9148). The large amount of commissions generated in her account, the volume of activity, the absence of a signed options agreement accepting the risks of options trading, and the lack of information concerning the customer raised serious questions – which we do not believe were satisfactorily resolved by the Exchange's investigation concerning suitability, lack of adequate disclosure, churning, and supervision. Another case concerned Leslie T. Peterson's Merrill Lynch, Pierce, Fenner & Smith Inc. employment application. That application disclosed a customer's lawsuit based upon Peterson's activities at Hutton (I-9130). While the Exchange contacted Hutton for information concerning the litigation, the CBOE does not appear to have verified Hutton's representations with respect to the lawsuit, determined whether any other complaints were outstanding against Peterson, or reviewed any of his other accounts at Hutton. As mentioned by Katharine Emmons of my staff to Edward Provost of your staff on June 24, 1981, several customers had complained to the NASD regarding Peterson's activities at Hutton and, moreover, the termination notice Hutton filed with the NASD for Peterson was materially different from the notice filed with the CBOE, insofar as Hutton did not inform the CBOE of the existence of those other customer complaints. In both of these investigations, the Exchange staff concluded that there were no reasonable grounds for finding that a violation had been committed and did not present the investigations to the BCC.

The staff noted one instance of significant delay in the commencement of the on-site investigation of several related cause matters. In the case of five investigations concerning Hutton which were referred to the Office of Member Firm Examinations in June, 1980, no on-site investigation had been commenced at the time of the staff's inspection in November, 1980, even though the routine examination of Hutton had been commenced in June, 1980 and was still in progress in November, 1980. Accordingly, we suggest that for those cause matters requiring on-site examinations which cannot be investigated promptly as part of a routine examination, the CBOE schedule a special examination in order to assure timely investigation.

In the formal disciplinary program, the staff found that the Exchange's files did not always fully document the progress of each case. The disciplinary files often did not reflect settlement negotiations and generally did not contain contemporaneous notes or memoranda of telephone conversations although we understand that under informal CBOE procedures any such documentation may be kept in the personal file of the responsible attorney. We recommend that notes or memoranda of telephone conversations or settlement negotiations be maintained in the Exchange's files with respect to each disciplinary matter.

Another, related concern noted in the area of disciplinary matters is the failure of the CBOE's disciplinary files in some cases to reflect fully the disposition, and rationale underlying such disposition, of each formal action. For example, the files regarding the statements of charges against Icahn Options Management Co. Inc. (80-0020), Donaldson, Lufkin & Jenrette Securities Corp. (80-0006), and The Chicago Corp. (79-0113) lacked evidence of a letter of caution or the firm's responses to letters of caution. In the case of Goldman, Sachs & Co. (79-0101), the staff was unable to determine the rationale of the BCC for the dismissal of formal charges, and in the statement of charges against A.G. Becker, Inc. (80-0041), the BCC authorized, without any explanation in the file, the amendment of the statement of charges to

allege violations of rules where no corresponding violations were found in the underlying examination. We therefore wish to be advised of the procedures you will adopt to assure adequate documentation of the disposition and rationale of that disposition for each formal action.

Finally, with respect to the Options Study recommendations and the Exchange's representations in response thereto,<sup>1</sup> the staff noted that the CBOE does not always verify evidence by contacting customers where appropriate. For example, in the two cause matters discussed above,<sup>2</sup> we believe that customer contact would have been helpful in attempting to verify the member firms' assertions. In addition, the staff found that the Exchange does not always contact other self regulatory organizations prior to conducting routine and cause examinations, and does not always document such contacts when they do occur.<sup>3</sup> The staff also noted that the Exchange does not maintain a record of oral customer complaints. The Exchange originally stated its intention to maintain written records of oral complaints not followed by a written complaint. Nevertheless, in order to assure the investigation of oral complaints which are not followed by a written complaint, we recommend that the Exchange maintain a separate record of each oral complaint by, for example, maintaining a sufficiently detailed log of such complaints to permit the entries to be used when planning examinations.

On behalf of the inspection team, I would like to thank you for the cooperation extended by the Exchange during the inspection. I understand that you intend to respond to the staff's concerns described in this letter. If you have any questions or wish to discuss any of the matters before you respond, please feel free to contact Lawrence R. Bardfeld at 202-272-2793 or Katharine S. Emmons at 202-272-2798. I look forward to receiving your response in the near future.

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<sup>1</sup> Letter dated August 15, 1979 from Scott L. Lager, Executive Vice President and General Counsel, CBOE, to Andrew M. Klein, Director, Division of Market Regulation, in response to Securities Exchange Act Release No. 15575 (Feb. 22, 1979). That release published, in a concise form, the recommendations of the Options Study.

<sup>2</sup> Complaint of Marion Stevens (I-9148) and disclosures on the application of Leslie T. Peterson for employment with Merrill Lynch, Pierce, Fenner & Smith Inc. (I-9130).

<sup>3</sup> See, e.g., 1980 routine main office examinations of Blunt Ellis & Loewi Inc. and Piper, Jaffray & Hopwood Inc.

Sincerely,

Douglas Scarff  
Director