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(202) 272-2650

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THE OPTIONS MARKETS COME OF AGE: THEIR PAST, PRESENT AND FUTURE

An Address by
Commissioner Barbara S. Thomas
U.S. Securities and Exchange Commission

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NOTE: This is the final draft of Commissioner Thomas' remarks. Although this draft may be quoted, the Commissioner might have made minor revisions during her oral presentation.

I am delighted to appear before this distinguished group today to discuss what I believe is one of the most important developing areas in the securities markets -- the options markets. From approximately 25 million options contracts in 1975, volume has increased steadily to nearly 97 million contracts in 1980. With this ever increasing volume of options trading, the lifting of the options moratorium in 1980, and the development of new options products, such as options on GNMA securities, the options markets clearly have come of age.

Although, of course, I cannot speak for the entire Commission, this morning I would like to share with you some of my preliminary observations with respect to the options marketplace. Specifically, I will first highlight some of the major developments which led to the maturation of our options markets. Next, I will briefly describe what I believe is the appropriate regulatory structure for the options markets. Finally, I will discuss a few of the issues which are currently before the Commission regarding options trading.

I. History of the Options Markets

Turning first to the history of our options markets, it is important to recall the tremendous suspicion with which options trading was initially viewed. Following the Great Crash of 1929, Congressional and private studies during the early 1930s exposed widespread manipulative and fraudulent practices involving the concurrent trading of over-the-counter options and stocks. In light of these concerns, pressure arose to prohibit the expansion of options trading to the national securities exchanges.

Nevertheless, in recognition of the legitimate financial ends options might serve, Congress, in adopting the Securities Exchange Act of 1934, chose not to impose an absolute ban on exchange-traded options. Rather, Congress gave the SEC broad discretion to determine the extent and manner of options trading on exchanges while, at the same time, granting the Commission full authority to adopt regulatory safeguards designed to curb the fraudulent and manipulative uses of options that had been exposed.

From 1934 to 1973, put and call options continued to be traded exclusively over-the-counter. In 1973, however, the Commission approved the application of the Chicago Board Options Exchange to register as a national securities exchange in order to conduct a pilot program for the trading of listed call options. Subsequently, as you know, the Commission approved listed options trading on the American, Midwest, Pacific and Philadelphia Stock Exchanges and authorized the limited trading of put options.

Following these initial steps, options trading quickly grew into an active marketplace. Nevertheless, despite the good faith efforts of many concerned individuals, abuses in the trading and selling of listed options began to appear, and the Commission became concerned about the adequacy of the regulatory environment surrounding listed options trading. Consequently, in July of 1977, the Commission requested each of the options exchanges to observe, in effect, a moratorium on the listing of

any additional options or the expansion of their options programs. At the same time, the Commission announced its determination to conduct a general review of standardized options trading in order to ascertain what, if any, additional action was needed to protect investors and ensure fair dealing in the trading of listed options and their underlying securities.

In February of 1979, the Commission released its Report of the Special Study of the Options Markets. Although the Options Study found many legitimate uses for options for those who understand and are able to bear the risks of options trading, it also uncovered many abuses in the options markets. The Study recommended that certain specified measures should be taken by the self-regulatory organizations, together with their members and the Commission, to improve the regulatory framework within which listed options trading had developed.

In particular, the Options Study found that improvements were needed to maximize the effectiveness of market surveillance efforts by the exchanges to detect manipulative conduct, the misuse of non-public information, and violations of various exchange options trading rules. The Options Study also found significant problems associated with options selling practices, including unsuitable recommendations to customers, excessive and unauthorized trading in customer accounts, inadequate training of registered representatives and options supervisors, and deceptive advertising and sales literature. Accordingly, the Options Study recommended revisions in the internal supervisory controls of

brokerage firms and changes in the surveillance and other oversight activities of the self-regulatory organizations. The Study also recommended amendments to exchange options rules designed to protect investors from improper options selling practices and to foster better understanding by public customers of the risks associated with options trading.

As a result, the options exchanges, the New York Stock Exchange and the NASD all formed a joint task force to address the Study's concerns and recommendations. Following extensive discussions with the Commission's staff, uniform proposals were submitted to the Commission. The Commission found that these proposals responsibly addressed the major regulatory deficiencies identified by the Options Study, and, on March 26, 1980, it approved the proposals and terminated the options moratorium. Since then options trading has continued to expand with, if anything, increased vigor.

II. The Options Regulatory Structure

With this short history of the options markets behind us, it is now natural to look briefly at the present regulatory structure for the options markets. The rules and regulatory programs adopted in response to the Options Study's recommendations affect all aspects of the options industry, including broker-dealers, the self-regulatory organizations and the Commission. In large part, these programs appear to have proven effective. Moreover, I believe the effectiveness of these programs flows directly from the fact that they were built upon

the concept of self-regulation which has been the traditional cornerstone of the securities markets.

A. The Role of the Broker-Dealer

Specifically, broker-dealers have, of course, first-line supervisory responsibility for their own options activities. In this regard, the new options rules which govern the internal supervisory controls of member firms are perhaps the most important aspect of the enhanced self-regulatory system for options. I believe that most sales practice abuses can be prevented through effective supervisory controls which have the demonstrated support of top management. Obviously, both investors and the industry benefit when problems can be solved through informal, in-house action without requiring more bureaucratic or public solutions.

B. The Role of the Self-Regulatory Organization

The next line of defense is the self-regulatory organizations. They are charged by statute with a duty to ensure that the rules applicable to options trading are complied with by their members and associated persons. In order to ensure the fairness and integrity of the options trading markets it will be critical for the SROs to maintain high quality trading surveillance systems. In addition, the improved SRO oversight of broker-dealer compliance programs should be an effective method, if vigorously pursued, to minimize the occurrence of sales practice abuses. Finally, an effective self-regulatory system also requires appropriate discipline of persons who violate

applicable rules. Therefore, the SROs and their member firms must not be hesitant to initiate disciplinary action where there are likely violations.

C. The Role of the Commission

The final element in the successful operation of the options regulatory pattern involves the Commission's oversight of the industry and the SROs. In this regard, the Commission has created an office, in its Division of Market Regulation, whose primary function is to conduct regular on-site examinations of the SROs' surveillance and compliance programs. In addition, of course, the Commission always stands ready to take direct enforcement action, when necessary, to ensure the protection of investors and the operation of fair and honest securities markets. Indeed, now that the options marketplace is eight years old, the options moratorium is over, and the new SRO rules are in place, I believe that the Commission will be looking for more rigorous compliance efforts by the exchanges and the broker-dealer community itself.

III. Future Issues for the Options Markets

With the history of the options markets in mind and acknowledging the soundness of the new regulatory structure for options, I would like, finally, to discuss three continuing and future issues which will challenge the options markets. First, although the options regulatory structure appears to be strong, we still need to consider whether any further refinements are possible. Second, we need to improve the quality and readability of the disclosure documents delivered to options investors. A

technically accurate, but unreadable, disclosure document does not protect investors or provide them with the necessary information to determine whether to buy or sell options. Third, we need to move carefully to ensure that new options products are developed in a responsible manner.

A. Central Customer Complaint Registry

With respect to the options regulatory structure, the Commission is still considering additional measures recommended by the Options Study. One suggestion, which has attracted attention, is that the SROs establish a central information registry for customer complaints received by the self-regulatory organizations, their member firms and the Commission. The Options Study contemplated that such a registry would provide the SROs with ready access to complaint data on a timely basis. This would significantly enhance the SROs' ability to detect operational problems and selling practice abuses.

Although the self-regulatory organizations initially were in apparent agreement as to the usefulness of such a registry, they were reluctant, for legal reasons, to establish a centralized system for sharing customer complaint information without a Commission rule specifically authorizing its establishment. As a result, the Commission recently proposed a rule that would require all SROs and registered broker-dealers to forward copies of all written, securities-related customer complaints to a central registry for the maintenance of such information. It is currently contemplated that the NYSE would establish a registry

for its members, while the NASD would establish a registry for the balance of the industry.

I am told that this proposal has elicited a great deal of adverse comments from many broker-dealers and exchanges. Specifically, some of them asserted that the proposal would impose new and unnecessary reporting requirements. As a preliminary matter, it appears that some of the comment letters reflect a misunderstanding of the intended scope and coverage of the proposed rule. The rule was not intended to establish the extensive, continuous reporting burden that some envision. Instead, the Commission believed that broker-dealers could comply with the rule by merely forwarding to the registry two kinds of documents. First, simple copies of customer complaints, which most broker-dealers already are required to maintain under SRO rules, and, second, a brief summary and no supporting documentation of the final action taken by the broker-dealer with respect to those complaints. The proposed rule is not intended to expand the duties of broker-dealers to investigate customer complaints beyond those to which they already are subject, nor would it require a broker-dealer to forward copies of internal firm correspondence regarding such complaints.

Nevertheless, the Commission takes very seriously its obligation to ensure that its regulations do not impose undue burdens on broker-dealers or the exchange community. Therefore, I will personally urge the Commission to look very closely at the proposed rule to ensure that, if adopted, it is cost-justified

and reasonably likely to fulfill its objective with only minimal intrusions on current industry practice. In this respect, I am especially concerned that the Commission, in its zeal for complete information, ought not to impose costs which, although necessary to obtain some useful information, are not necessary from the broader perspective of the entire self-regulatory system.

B. Improving the OCC Prospectus

A traditional goal of the self-regulatory system, and the Commission's activities, has been to ensure that investors are adequately informed about the nature and risks of their investments. In this regard, another recommendation of the Options Study relates to the Options Clearing Corporation prospectus. Because the OCC issues, registers, and guarantees all listed options, an OCC prospectus is required to be delivered to every customer at or before the time his or her account is approved for listed options trading; just as if the OCC were a corporation issuing its securities to the public for the first time. The Options Study, however, found that, in its current form, the OCC prospectus is too technical and complex to meet the needs of individual investors, many of whom may lack the financial background necessary to understand the prospectus. The Options Study, therefore, concluded that information about the OCC, as the nominal issuer of all listed options, be deleted from the document. Instead, the Study suggested that investors be provided with a disclosure document that presents, in a manner

understandable to a reader with no financial training, a description of the risks, uses, terms and mechanics of options and options trading, as well as a discussion of the transaction costs, margin requirements and tax consequences of options trading. The Commission staff has been working with the OCC for some time to develop such a disclosure document.

I, personally, strongly concur with the view that the current OCC prospectus is too complex to serve as the basic disclosure document for public investors and, accordingly, I fully support the efforts to create a document whose coverage, while sufficiently extensive to ensure that investors are able to make informed investment decisions, provides a more readable and understandable presentation of the subjects covered.

C. New Products

The need for informed investors in options will be further highlighted by the development of new options products. This is one of the most significant policy areas and dilemmas currently facing the Commission. As I mentioned earlier, the Commission recently approved a proposal by the CBOE to permit the trading of standardized options on GNMA securities. These are the first options on a non-equity security ever approved by the Commission. The NYSE has filed a similar proposal, which was released for public comment on February 26, 1981. In addition, the American Stock Exchange, Chicago Board Options Exchange and the New York Stock Exchange have filed proposals to trade options on Treasury instruments. The Philadelphia Stock Exchange has proposed to

trade options on five foreign currencies and the Pacific Stock Exchange has proposed to trade options on gold coins, initally the Krugerand.

Consideration of each of these extremely complex proposals in a timely fashion poses a formidable challenge to the Commission. Each proposal raises difficult and unique issues which must be thoroughly explored. While this necessarily is a time consuming process, I believe that the Commission's relatively quick resolution of the numerous difficult questions associated with the GNMA options proposal demonstrates our commitment to consider new product proposals as expeditiously as possible.

I believe that the GNMA options proposal of the CBOE is an appropriate first step in the development of exchange trading of non-equity options, particularly in view of the widespread industry and governmental support for the proposal. Specifically, both the industry representatives and other governmental agencies who commented on the proposal asserted that exchange-traded GNMA options could play a vital role in promoting the public interest by facilitating capital formation in the housing industry and by allowing GNMA to fulfill more effectively its responsibilities in connection with the housing market. I hope trading experience will prove these optimistic expectations to be justified.

Although I am still considering the specific issues, as a general matter, I believe the Commission should encourage

experiments with new product options to the extent they serve to develop the legitimate uses of options as investment vehicles. In addition, if the proposals do not give rise to regulatory concerns, I believe that the Commission should not attempt to substitute its judgment, for that of the exchanges and ultimately the marketplace, in the development of particular contract designs for new options products.

At the same time, however, the Commission must carefully consider the consequences of each proposal. For example, we must consider what effect the creation of an options market will have on the market for the underlying instrument. In this regard, the Commission has been consulting with other interested government agencies, including the Treasury Department, the Federal Reserve Board and the Commodity Futures Trading Commission, in evaluating the new options proposals. Moreover, in light of the novel and complex nature of the proposed instruments, the Commission must take particular care to ensure that the proposals incorporate adequate investor safeguards to prevent any recurrence of the abuses that marked the early stages of listed options trading. Specifically, any new proposal must ensure that broker-dealer personnel who sell or supervise the sale of such options are properly trained and qualified and that public customers who invest in new product options are aware of the attendent risks, and are not sold options that are unsuitable in view of the customer's investment objectives and financial resources. But, in view of the industry's constructive reaction to the Options

Study's recommendations, I am encouraged to believe that new products will be dealt with in a similarly responsible fashion. Accordingly, I hope that new products can continue to be implemented expeditiously.

IV. Conclusion

In conclusion, allow me to recall Ben Franklin's wise remarks. "Those who govern . . . do not generally like to take the trouble of . . . carrying into execution new projects. The best public measures are therefore seldom adopted from previous wisdom, but forced by the occasion." Fortunately for the Commission, however, the tradition of self-regulation has allowed us to rely, as we should, on industry leadership in the development of new and important investment vehicles. For my own part, I prefer to continue that reliance so long as the exchange community remains sensitive and fully responsive to the needs of the companies whose securities underlie options, the broker-dealer community, and the investing public. Indeed, as a result of the reforms adopted at the conclusion of the options moratorium, I am confident that, through the joint efforts of the options industry and the Commission, we will meet future challenges, and thus enhance the quality and competitiveness of our options markets.