

Chapter Six

Option Compliance and Account Supervision

Introduction

A member firm's option business must be supervised by the firm's registered option principals. Member firms must also designate an option principal as a senior registered option principal (SROP) and the SROP must be an officer or partner of the firm. A firm is also required to designate a registered option principal as a compliance registered option principal (CROP). The CROP will report to the firm's senior management and is not required to be an officer or partner of the firm. While the duties of the SROP and CROP are different, the firm may designate the same individual as the SROP and CROP.

Duties of the SROP

The senior registered option principal or SROP's duties mainly focus on the supervision of the member firm's option business. The SROP must supervise all of the member firm's option transactions with customers and is additionally responsible for:

- ✓ Developing the firm's written supervisory procedures relating to option business
- ✓ Developing the firm's training program for option business for RRs and ROPs
- ✓ Reviewing discretionary account acceptance by branch managers
- ✓ Working with and assisting branch managers in supervising customer accounts

The SROP must also design and administer supervision programs to review selected option accounts to ensure proper supervision. The SROP may delegate most review and supervision duties to employees (usually ROPs) under their direct control but remains responsible for all of the areas of supervision.

Duties of the CROP

The compliance registered option principal or CROP, as the name suggests, is responsible for ensuring that the member firm's option business complies with all laws and industry regulations relating to option business. Unless the firm is a small firm with less than \$1,000,000 in commission business from option transactions in either of the last two years or has less than 10 agents conducting option business, the CROP may not have any sales function at the firm. The CROP must:

- ✓ Establish the firm's record keeping procedures relating to options
- ✓ Review selected option accounts frequently
- ✓ Establish guidelines and requirements for the firm's option advertising
- ✓ Approve all option advertising and sales literature prior to first use
- ✓ Supervise account approval procedures
- ✓ Supervise the creation of account approval forms
- ✓ Develop the firm's option training program with the SROP

- ✓ Review option discretionary accounts more frequently
- ✓ Supervise the firm's procedures for allocating assignment notices
- ✓ Audit the firm's option compliance program

Option Account Compliance

A member firm's option business requires strict supervision from the SROP and CROP as well as from the firm's ROPs and branch office managers. All customer option accounts must be approved in writing by a ROP. Not all customers will be approved to trade options and not all customers who are approved to trade options will be approved for more advanced or more risky option strategies. In order to determine if a customer should be approved to open an option account, the registered representative must collect as much financial information from the customer as possible. The registered representative must collect the following information:

- ✓ Full name and address
- ✓ Home and work phone numbers
- ✓ Social security or tax ID number
- ✓ Employer, occupation, and employer's address
- ✓ Net worth and liquid net worth
- ✓ Investment objectives
- ✓ Investment experience
- ✓ Estimated annual income
- ✓ Whether the customer is employed by a bank or broker dealer
- ✓ Marital status

NOTE

If the customer is employed by an NYSE member firm, an exchange or the OCC, the firm opening the account must obtain the employer's written permission for the customer to open the account, and duplicate confirms and statements must be sent to their employer.

Based on the information collected by the agent, the ROP must determine whether or not option trading is suitable for the customer. Most customers will be approved to write covered calls against long stock positions. Writing covered calls is considered to be a conservative strategy. Customers must be able to demonstrate additional levels of sophistication and financial liquidity to be approved for:

- ✓ Buying puts and calls
- ✓ Spreads and straddles
- ✓ Writing uncovered options

Only customers who demonstrate the highest levels of sophistication and liquidity will be approved to write uncovered options. If a firm does allow customers to establish uncovered option positions, the firm must have specific written supervisory procedures detailing suitability requirements and minimum net equity requirements for customers. Additionally, the firm must send customers who are approved to establish uncovered

option positions a special risk disclosure document relating to uncovered options prior to or at the time the first uncovered option position is established. This risk document details the fact that many uncovered option positions will have the potential for an unlimited loss. If the branch office manager is not a ROP, the branch office manager may initially approve the account to trade options so long as a ROP also approves the account promptly. Each customer who opens an option account must be given the OCC's risk disclosure document detailing the risks and characteristics of standardized options at or prior to the time the account is approved for option trading. Certain customers will have to provide additional information to document that option trading is allowed. Trusts, corporations, and pension plans will be required to provide additional documents to demonstrate that option trading and, if applicable, margin accounts are permitted. Discretionary accounts will require the customer to sign a limited power of attorney. The limited power of attorney will stay in effect until the customer revokes it or dies. All discretionary option accounts should be approved in writing by both a ROP and SROP. The record of the SROP's review and approval of the account must be maintained by the firm and the account should be reviewed more frequently to ensure against churning. If the agent is going to employ a systematic option program for the discretionary account, the account holder must get a detailed description in writing of the program to be used.

Regardless of the type of account, each option order must be approved on the day that the order is entered. Option orders are not required to be approved prior to being entered by an agent but must be approved promptly by a ROP on the day the order is entered.

Option Agreement

All new option accounts must be approved by the registered options principal prior to the first option trade. An option investor must sign and return the option agreement within 15 days of the account's approval to trade options. If the investor fails to return the option agreement within 15 days, no new option positions may be opened and the investor will be limited to closing transactions only until the option agreement is signed and returned. By signing the option agreement, the customer agrees to notify the firm of any significant change in their finances and the customer:

- ✓ Agrees to abide by all OCC and exchange rules
- ✓ Acknowledges that they have received and read the OCC risk disclosure document
- ✓ Understands any long options in the money by 25 cents or more at expiration will result in automatic exercise for the customer
- ✓ Understands payment, exercise and assignment terms

Option Account Supervision

Customer option accounts require strict supervision to ensure compliance with all relevant rules and to ensure that customers only trade options within their approval limits. As customers and agents manage positions, it is quite possible for a customer's account to end up with an option position that is not within the customer's approval limit.

ROPs must review customer accounts frequently to ensure customers stay within their approved guidelines. It would be quite possible for a customer whose account is approved for covered calls only to end up with a naked option position if they sold the underlying stock without covering the short options. If a customer's account contains a position which is outside of its approval limit, written procedures must be in place detailing how to appeal to the ROP for an exception or the options must be covered promptly. ROPs must pay close attention to the relationship between customer approval limits and customer positions. When reviewing customer accounts, a ROP should also pay close attention to:

- ✓ Any churning or excessive commissions earned from the account
- ✓ The amount of options positions relative to the size of the account
- ✓ Frequent Reg. T extensions
- ✓ Profits and losses for option trades
- ✓ Suitability
- ✓ Any unauthorized transactions
- ✓ Any positions established that cannot result in a profit or are not economical
- ✓ Any suspicious activity i.e. trading on inside information and front running
- ✓ Ensure the customer does not exceed position limits
- ✓ Any manipulative activity such as capping or pegging

It is quite possible for an investor or trader to use options to profit unduly from the knowledge of a large order and to front run the block by entering an order to buy or sell options on the stock. Similarly, a trader or investor could use options to trade on inside information and to profit unduly from non-public material information. To guard against these situations, ROPs will look at the account's option trading history and the time the option order is executed relative to the block transaction or relative to the release of material information. Orders executed just prior to a block transaction or just prior to the release of material information are more suspicious than orders executed much earlier. Additionally, transactions that are outside the account's normal trading practices would raise a red flag as well. For example, if an account's normal option trade is 10 contracts and the order being examined is for 100 contracts, that would be a cause for concern.

An option trader who has a large option position may be tempted to try to manipulate the price of the underlying stock through capping or pegging. An investor who is long a large number of put contracts may be tempted to enter orders at the end of the day to sell the underlying security to keep the stock price down. This action would be an example of capping. If the same trader was short a large number of put contracts, the trader may be tempted to enter orders at the end of the day to buy the underlying security to keep the stock price up. This would be an example of pegging. Both capping and pegging

activities should be guarded against by the ROP and are more likely to occur in the firm's proprietary trading account or in the account of an institutional customer.

Customer Confirmations and Account Statements

All customers must be provided with a trade confirmation when an option order is executed. All confirmations must be sent to the customer no later than the option's settlement date or T+1. Option trade confirmations must disclose:

- ✓ The type of option
- ✓ The type of transaction, buy or sell
- ✓ The underlying security
- ✓ The number of contracts
- ✓ The exercise price
- ✓ The expiration date
- ✓ If the transaction was to open or close
- ✓ The trade date
- ✓ The settlement date
- ✓ The premium and amount due or owed
- ✓ The commission charged
- ✓ If the firm acted as a principal or as an agent in the transaction

A customer must receive a statement every month in which there is activity in the account. All customers must receive account statements at least quarterly when there has been no activity in the account. Examples of activity include:

- ✓ Purchases and sales
- ✓ Dividend and interest received
- ✓ Interest charged
- ✓ Addition or withdrawal of cash or securities

Customer account statements must show:

- ✓ All positions in the account
- ✓ All activity since the last statement
- ✓ All credit and debit balances

Brokerage firms are required to disclose their financial condition to their clients by sending them a balance sheet every six months or on the request of a customer with cash or securities on deposit. Customer account statements must be maintained for six years and account statements must contain a notice requesting that the customer notify the firm of any material changes in their investment objectives or financial status.