

B. SUPERVISION OF ACCOUNTS

1. Introduction

The intricacies associated with trading options are such that strict supervision of each registered representative's activities by his brokerage firm is essential to the protection of public customers.

The self-regulatory organizations impose a duty on brokerage firms to supervise the professional conduct of their employees, and the Exchange Act provides for the imposition of sanctions upon any brokerage firm (or responsible employee) which fails in its supervisory obligations. 8/

The NASD's rule is the most explicit of the self-regulatory organizations' rules in spelling out the obligations of its member firms to supervise. In essence, member firms must have and use written supervisory procedures, which a designated partner, officer or office manager is responsible for carrying out in each "office of supervisory jurisdiction." 9/ Further, in order to supervise employees adequately, member firms must: keep necessary records;

8/ Section 15(b)(4)(E), Securities Exchange Act of 1934, 15 U.S.C. 78p(b) (1978).

9/ An "office of supervisory jurisdiction" means any office, including branch offices, designated as directly responsible for the review of the activities of registered representatives. NASD Rules of Fair Practice, Art. III, § 27 (f), NASD MANUAL (CCH) ¶ 2177.

review the activities of each of their offices, "including a periodic examination of customer accounts, to detect and prevent irregularities and abuses"; conduct an inspection, at least annually, of each office which has supervisory jurisdiction; and review and initial all relevant transactions and correspondence of the firms' registered representatives who solicit or execute securities transactions. 10/

That these requirements apply to an "office of supervisory jurisdiction" reflects the generally decentralized management structure of many brokerage firms that do business with the retail public. Brokerage firms usually maintain a central or headquarters office and various regional and branch offices, each under the supervision of a designated manager. The Options Study has found that customer-related problems often proliferate when a firm's supervisory procedures do not adhere to the above rules and are not carried out consistently from one office to the next. The problems are exacerbated for options customers because current regulatory requirements do not assure that supervisors knowledgeable in options will oversee the options business of the firm, either in the central office or the branch offices.

10/ NASD Rules of Fair Practice, Art. III, § 27, NASD MANUAL (CCH) ¶ 2177.

2. The ROP System

When the CBOE introduced trading in listed options, it recognized that firms offering this new and complex product to the public ought to have one person within the firm's management structure who possessed some expertise about listed options. Accordingly, the CBOE required each member firm to designate one officer or general partner to be the firm's "Registered Options Principal" ("ROP") who would be responsible for "the supervision... of all [the firm's retail] customer accounts" insofar as those accounts traded options. ^{11/} The ROP would be required to pass a qualifying examination in options.

The CBOE, however, did not fashion its rule to fit the decentralized management structure of broker-dealer firms. Instead of requiring that the options business of each sales office of a firm be supervised by an ROP, it provided only for the designation of one home office ROP. As other exchanges began to offer options, they, too, adopted the ROP concept and required that their members designate an officer or partner to be the firm's ROP. ^{12/} Like the CBOE, the other exchanges

^{11/} Rule 9.8, CBOE GUIDE (CCH) ¶ 2309. Later, when the number of Registered Options Principals in each firm multiplied causing some confusion as to precisely where responsibility for compliance with exchange rules lay, CBOE revised its rules to reestablish the concept of a single senior managerial officer with supervisory responsibilities for the firm's overall options business. This new "chief" options supervisor was dubbed "Senior Registered Options Principal" ("SROP").

^{12/} See, e.g., Rule 920, 2 ASE GUIDE (CCH) ¶ 9720.

required that members designate only one options-qualified person to supervise the firm's entire listed options business.

The ROP concept is the primary supervisory innovation developed by options exchanges to deal with increased problems of supervision of options accounts. The ROP concept may eventually prove to be a sound principle on which firms may build acceptable options supervisory systems. The Options Study has found, however, that as presently designed and implemented, the ROP system is inadequate to assure proper supervision of a broker-dealer firm's business in listed options. The shortcomings of the present system are discussed below.

3. ROP Qualifications

The first problem with the ROP system of supervision is that controls for qualifying persons as ROPs historically have been inadequate. In addition, the ROP examination itself has been deficient in certain respects.

The current CBOE rules provide that "[p]ersons engaged in the management of [a member firm's] business pertaining to Option Contracts" may qualify to be designated a registered options principal by passing a written examination. 13/ The AMEX rule is virtually identical. 14/

13/ Rule 9.2, CBOE GUIDE (CCH) ¶ 2302.

14/ Rule 920, 2 ASE GUIDE (CCH) ¶ 9720.

Persons who take the ROP examination may ask to be qualified by both the CBOE and the AMEX or by either.

The examination is administered by the NASD under contract with the options exchanges and it is given at local NASD test sites. The major weakness of the current examination is that the same version of the test has been used numerous times so that specific test questions may be known to many applicants before they take the examination. In addition, the examination itself places too great an emphasis on the mechanics of options trading and not enough on the supervision of listed options trading. Approximately 90 percent of the current candidates successfully pass the ROP examination.

While the current examination, although not perfect, serves as a useful screening device for persons seeking certification as ROPs, the ROP qualification process did not always include a meaningful examination requirement. Before 1975, candidates could qualify for ROP certification simply by taking an open book examination administered at their own brokerage firms. In 1975, when the AMEX opened its facilities to options trading, and formalized ROP examination procedures were introduced, those persons who already had taken the open book test were exempted by the CBOE from the new examination requirements. As a result, more than five hundred existing ROPs have never been tested under controlled conditions. The failure of the CBOE to require that all member firm ROPs pass stringent, properly

administered examinations has allowed persons with questionable qualifications to become certified as ROPs. Not surprisingly, the Options Study has found cases where ROPs in critical compliance positions in brokerage firms have exhibited only a limited knowledge of options trading.

The growth of a strong ROP system would be beneficial for the protection of public investors, since bona fide ROPs should have enough expertise in options to enable them to supervise their firm's options business. The value of the ROP system is substantially reduced, however, if all ROPs are not required to successfully complete an examination given under controlled conditions at neutral testing sites. And, of course, for the examination to serve as a true qualification test of options expertise, it should require candidates to demonstrate substantial detailed knowledge of options and an understanding of rules and regulations concerning options trading. Accordingly, the Options Study recommends:

- (1) THE REGISTERED OPTIONS PRINCIPAL QUALIFICATION EXAMINATION SHOULD BE REVISED SUBSTANTIALLY TO TEST ROP CANDIDATES' UNDERSTANDING OF SUPERVISORY REQUIREMENTS RELATING TO OPTIONS AS WELL AS THEIR KNOWLEDGE OF OPTIONS:
- (2) ALL REGISTERED OPTIONS PRINCIPALS SHOULD BE REQUIRED TO SUCCESSFULLY COMPLETE THIS REVISED VERSION OF THE EXAMINATION ADMINISTERED UNDER CONTROLLED CONDITIONS.

4. Problems of Local Supervision

As noted above, the managerial structure of the brokerage industry is largely decentralized. Most firms rely heavily on branch office managers to supervise the conduct of registered representatives. The

arrival of listed options trading placed significant new responsibilities on branch managers, many of whom were unfamiliar with options and with the rules and regulations of the new options exchanges. Their lack of preparation notwithstanding, these managers were required to administer a new body of account approval, suitability and reporting rules; they also were expected to understand the mechanics of listed options trading and the various options strategies used by the registered representatives and customers in their branch offices.

Many branch managers have been unable to cope successfully with the supervisory challenges posed by listed options trading. The Options Study believes that several factors have contributed to their lack of success as options supervisors. These factors include:

- the training requirements for branch managers, who need not be qualified as ROPs under present options exchange rules;
- the prevailing methods of compensating branch managers, which favor commission revenue production over careful supervision;
- overall lack of support for local supervisors from the firm's central management.

a. Unqualified branch managers

As stated earlier, when trading began in listed options, the CBOE required member firms to designate one senior employee to become the firm's options supervisor (the ROP) but stopped short of requiring that each branch office of the member firm be managed by an ROP. It follows that many branch offices of broker-dealer firms are managed

by persons who know little about listed options regulations or trading.

For example, the Options Study found managers who:

- . tried to understand strategies employed by registered representatives under their supervision "only once" or "not at all" because they did not know how to analyze options trading activity or could not recognize the strategies being employed;
- . claimed to review customer options information forms only randomly and then not to determine whether options trading was suitable for the customer involved but rather "for [the manager's] own education";
- . did not know if their firms had criteria for determining suitability of options transactions;
- . did not know how many accounts in the branch office were trading options or approved for options trading;
- . did not know whether any accounts in the office had been rejected for options trading and relied upon the registered representatives in the office to know the manager's "thoughts" on a particular options account approval question rather than seeking approval in specific cases;
- . did not know that customer account statements were available in a microfiche file in their own branch offices;
- . had no written supervisory procedures for overseeing options trading in their offices.

In several of the instances set out above, public customers suffered losses that would not have occurred with adequate supervision of the activity of registered representatives selling options. The lack of training of the local supervisor contributed significantly to each problem.

When a branch manager lacks the necessary expertise to supervise the options business of his office, he sometimes delegates supervisory authority to a subordinate manager or even to a registered representative who holds himself out as an expert in listed options trading. The Options Study has reviewed a number of cases in which such delegations have led to confusion of responsibilities or, in effect, have resulted in the very registered representative who is most in need of supervision being permitted to supervise himself. For example:

- . a manager allowed a registered representative to perform the manager's daily compliance function of initialing all trading tickets in the registered representative's own discretionary accounts;
- . a manager allowed registered representatives to approve their own customer accounts for options trading;
- . one registered representative was permitted to receive and maintain all copies of customer account records;
- . in one situation, a branch manager and his subordinate each claimed that the other was responsible for the conduct of customer suitability reviews, which were never performed;
- . one manager, who felt his background in sales had not prepared him to supervise listed options trading, turned over all supervisory authority to his operations manager, whom he then failed to supervise;
- . one branch manager who knew of a growing number of customer complaints against one registered representative selling options and knew of other problems in the registered representative's accounts, left on a two-week vacation without giving his assistant manager any instructions concerning the supervision of this registered representative.

In several of the above instances, public customers suffered harm because inadequate supervision, resulting from inappropriate delegation of authority, which allowed a registered representative to engage in improper

conduct. Problems of delegation have been particularly serious in some satellite or sub-branch offices, where the primary supervisor is not on the premises.

Some firms have come to recognize that proper supervision of registered representatives' options activities at the local level requires the presence of an ROP with supervisory responsibilities in each branch. More than 25 percent of the firms in the industry group sample now require their branch office managers to be ROP-qualified, and approximately 57 percent of all the branch managers of firms in the industry group sample are ROP-qualified.

While the presence of an ROP-qualified supervisor in each brokerage firm's sales office would not alleviate all the options sales practice problems which result from a breakdown in supervision, such a requirement would be a basis for sound supervision in the local sales office.

Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD ADOPT RULES
TO REQUIRE THAT THE PRINCIPAL SUPERVISOR OF ANY
AND ALL OFFICES ACCEPTING OPTIONS TRANSACTIONS BE
QUALIFIED AS AN ROP.

b. Compensation of local supervisors

Several conflicts of interest are inherent in the current system of branch manager supervision. The most serious of these conflicts spring from the method by which brokerage firms compensate branch managers. Most brokerage firms compensate their branch managers, in

whole or in part, on the basis of the manager's own commission production and on the profitability of the office he manages. The following table sets out the practices of the firms in the industry group sample with regard to compensating sales office managers.

COMPENSATION OF SALES OFFICE MANAGERS

<u>Method of Compensation</u>	<u>Percentage of Firms in Sample</u>
Own commission production plus bonus or percentage of office commission production	38%
Salary plus own commission production plus percentage of office commission production	21%
Salary and bonus	19%
Percentage of office commission production	16%
Profit participation above profit quota for office	3%
No response	3%

These results show that at least 78 percent of the firms in the sample expect branch managers to look to either their own sales efforts, or the sales commissions generated by the branches they manage (or a combination of both) for some or all of their compensation. In addition, 91 percent of the industry group sample told the Options Study that they allow local sales office supervisors to service their own customer

accounts. These conditions offer temptation for a local manager to favor the commission production of his office or of his own sales efforts over the requirements of proper supervision.

It is equally apparent that when the branch manager spends much of his working day servicing his own accounts, he has less time for supervision of the activities of other salespersons and, particularly, for the detailed financial analyses sometimes required to oversee adequately customer options trading.

The incentive provided to a local manager to favor commission production rather than supervision is evident in the following testimony of a registered representative regarding his branch manager's attitude toward supervising a very active customer account:

EXCERPT FROM TESTIMONY OF AN OPTIONS SALESMAN - November 10, 1977

LAWYER: Now, you mentioned that you discussed [this investor's] option account with [your supervisors]...

* * *

Do you recall anything that [your branch manager] ever told you in connection with the commissions that [this investor] was generating?

SALESMAN: Not really, no, just enjoy it while it lasts.

* * *

LAWYER: What did you understand [the branch manager] to mean when he said to you, "Enjoy it while it lasts?"

* * *

SALESMAN: That eventually, you know, he'll probably move on to another brokerage firm, you know, blow himself out of the water.

* * *

LAWYER: Was there any discussion of what could be done to help [the investor]?

SALESMAN: Not to help, no. [The branch manager] just said that, you know, make sure that we get the money. Okay? Keep him posted. And I think I remember [the operations manager] mentioning that this account may have to be restricted because of the fact that he had now had three purchases which he had not paid for in cash, but had sold, you know, after the purchase, days later, which first was like a free riding, and after three of those things, the account is to be restricted. ... And then [the branch manager's] comment was that 'we will never restrict the account.'

LAWYER: Did he say why?

SALESMAN: No. It was understood. There was a big -- you know, a big revenue machine.

In nearly every significant case of fraud encountered by the Options Study, there has been a local breakdown of supervision caused, at least in part, by the conflict of interest engendered by a manager's own interest in commission production and his responsibilities as a supervisor. The most serious manifestation of this conflict is the tendency of local managers to pamper large commission producers even to the point of ignoring clear indications that the "producer" is not properly servicing his customers' accounts. One branch manager testified about

how delighted he was to have two options salesmen who were "high producers" in his employ. He actively recruited customer accounts for them, even though he had strong indications that both salesmen had caused and were causing serious problems in their handling of customer accounts.

The financial inducements to humor the large commission producer are reinforced by the manager's awareness that registered representatives generally are free to go where they please and to choose a firm where supervisory conditions are favorable to their ways of doing business. Since a registered representative who leaves a firm often succeeds in taking with him many of his customers and the commission revenue production of those accounts, a manager whose own livelihood depends on such revenues may be disinclined toward vigorously "supervising" registered representatives whose activities generate substantial commissions.

This concern, not to lose a "big producer," is reflected in the following warning memorandum concerning the second largest options revenue commission producer in a major brokerage firm. In this memorandum, which was not heeded, the chief compliance officer of the firm told top management:

I asked [the branch manager] if he reviewed the ... monthly statements that were sent to him and he said "Yes, I just sign them and pray." He has made no effort to understand the activity

in [this registered representative's] accounts. He is clearly afraid that if he questions [this registered representative], [the registered representative] will resign and go to another firm.

Some managers have designated large commission producers "options coordinators" or "options product leaders", apparently in order to placate them, and then have failed to supervise their activities. One local supervisor refused to believe the problems that continually emerged concerning a team of registered representatives who sold exotic options programs, telling customers who complained that their complaints had no substance because "there would be red lights flashing and warning bells going off all over the place" if their complaints were true.

The problems caused by the effects upon sales office managers of the compensation structure are very difficult to control by regulation. The Options Study believes, however, that a firm's overall policies concerning its sales practices set the tone and the standards by which all the firm's employees conduct themselves. If the management of the firm makes clear that a branch's performance will be measured not just by commission production, but by customer satisfaction and fair treatment, the method by which branch managers are compensated would be a less serious impediment to sound supervision than it now appears to be.

c. Attitude of the Broker-Dealer Firm Toward Supervision

The Options Study has found that the attitude of a brokerage firm toward supervision either reinforces sound supervisory procedures

or, if misdirected, can seriously weaken the resolve of branch managers to supervise. The Options Study came across several cases in which prevailing attitudes within the firm undermined a branch manager's efforts to control a "big producer" and permitted the misconduct of the registered representative to continue. In one case, where the branch manager was aware of compliance problems concerning one team of options salesmen, he was also confronted by a letter from a regional sales manager of the firm to one of the team members congratulating him for recent production figures and expressing appreciation for his "fine efforts." In another case, where a branch manager expressed concern about the activities of two options producers to management at the home office, his warnings were ignored because of the home office's "high regard" for these large commission revenue producers.

Two case studies reviewed by the Options Study particularly illustrate how a firm's attitude toward the supervision of a registered representative who produces large commissions may permit serious misconduct to go unchecked.

CASE A

For more than six months, a large commission producing registered representative was nominally supervised by a vice president of a major brokerage firm who was located at a different address than the registered representative. The registered representative was given office space adjacent to special communications equipment, his own telex terminals

and his own alphanumeric code. Treated as the functional equivalent of an entire branch office, this registered representative, not his supervisor, was sent the supervisor's copy of customer statements and account analyses.

After several months of extremely active trading involving options in the registered representative's accounts, the vice president assigned to "supervise" the salesman warned his own superiors:

[This registered representative] cannot be effectively supervised from [his current location]

Although our basic gut feeling about [this registered representative] is good, his entire business is concentrated in [several] accounts, and there is no doubt in our minds [he] will bend over backwards to give these [several] accounts whatever they want. As a result, our exposure is considerable....

We have no papers as of yet for [a major] account, but understand that new account papers are on the way....

[The registered representative's] business is so large and complex, that daily on-the-spot supervision must be conducted.

The same memorandum then set forth a discussion of the profitability of the registered representative's activities for the year to date, annualizing figures to determine a "gross production" of \$650,000 and an approximate "profit to the office" of \$150,000. The memorandum concluded:

1. For the time being at least, we want [this registered representative].
2. We want him only if we can control him.
3. We must keep him happy..."

Two months later, the same vice president again warned his superiors about this same registered representative:

... my conclusion — that [this registered representative] cannot be effectively supervised under present conditions has not changed, and is based upon the following observations:

[This registered representative] needs the brokerage journals, daily transaction analyses, commission sheets, two sets of customer confirms, statements, etc., to effectively conduct his business. For that reason he will not release any of the foregoing, and since duplicates are not available, it's an impossible job to determine what he does over there (and, for that matter, how he does it)....

Despite these warnings, no effective steps were undertaken to supervise this registered representative's activities for another three months. During this period, the registered representative was able to perpetrate a complex fraud on his options customers to whom his brokerage firm eventually paid several million dollars to settle lawsuits.

CASE B

In March 1978, Mr. X was promoted to be manager and resident supervisor of a branch office of a major brokerage firm. About this time, Mr. X, one of the largest options commission producers in the firm, was featured by a national financial columnist as an options expert whose exotic options strategies had returned up to 20 percent on equity for pleased options customers during the just past year. The article went on to set out some of Mr. X's recommended options trades. Unknown to readers of this column and to almost all of Mr. X's own options customers, Mr. X's options accounts were actually in disarray as

a result of excessive trading and Mr. X's mismanagement. Ultimately, several of Mr. X's customers sued him and his employer for fraud and recovered substantial judgments.

Mr. X had been made sales manager and then a branch manager of the firm even though he had proved to be a constant supervision problem. Compliance personnel had warned Mr. X of excessive trading in his customer accounts, had asked in vain that he inform his customers of their account equity, and had requested, without success, that he tell the firm how many of his options accounts were discretionary. These problems had also been brought to the attention of senior management of the firm.

The top management of the firm, concerned that strict supervision over Mr. X might drive him out of the firm, had ignored repeated warnings about his performance from the compliance office and instead attempted to resolve amicably the problems which Mr. X had caused for his supervisors. For more than a year, the firm gently attempted to bring Mr. X and his customer options accounts under supervisory control. Management finally resolved the problem of supervising Mr. X by promoting him to branch manager. In this new position, Mr. X had supervisory control over his own activities and over the activities of several younger salesmen whose sales efforts were almost exclusively in listed options. At least one of these salesmen was subsequently the subject of options-related customer complaints.

The Options Study believes that sound selling practices require top management of a brokerage firm to be committed to a program of effective supervision and to demonstrate its support for such a program. A detailed program of supervision which incorporates the recommendations in this selling practices chapter as minimum standards could form the basis of an effective supervisory program. Accordingly, the Options Study recommends:

THE SELF-REGULATORY ORGANIZATIONS SHOULD DEVISE A UNIFORM DETAILED PROGRAM FOR SUPERVISION OF OPTIONS TRADING WITHIN MEMBER FIRMS WHICH WOULD ESTABLISH MINIMUM SUPERVISORY STANDARDS AND PROCEDURES AND WHICH WOULD ADDRESS THE ISSUES RAISED IN, AND INCORPORATE THE RECOMMENDATIONS OF, THIS CHAPTER AMONG THOSE STANDARDS AND PROCEDURES.

5. Home Office Supervision

For a broker-dealer firm's overall program of supervision to be acceptable, the headquarters office as well as the branch offices must have personnel who can oversee and support the work of supervisors at the sales offices. Certain types of options-related compliance matters, such as periodic surveillance of customer options transactions and the overview of options trading in a branch, are more appropriately performed by home office personnel properly qualified in options.

As already noted, the rules of the options exchanges require that member firms designate a principal or "Senior" Registered Options Principal ("SROP"), who is an officer or general partner of the firm, to be responsible for the supervision of options customer accounts.

The central, indeed unique, role assigned to the SROP in a firm's program of options compliance requires that the person designated as SROP not be given conflicting duties and responsibilities. Yet, many firms appear to regard SROPs more as sales promotion managers than as compliance officers. Well over half the firms in the industry group sample responded on the Options Study questionnaire that they assign to their SROP the job of heading the firm's options marketing program (56 percent). More than two-thirds of the firms in the sample assign to their SROP some selling function (68 percent).

The distraction of sales promotion responsibilities can prevent an SROP from focusing his complete attention on supervision of the firm's options activities. Moreover, if, as options sales manager, he is competing with other "product managers" (commodities, annuities, etc.), for the attention of registered representatives, he, like his branch manager counterpart, may be more interested in sales figures than in sound sales practices.

The co-opting of the SROP for sales promotion purposes, however, would not be of particular concern if someone else of stature within the firm, who had demonstrated options expertise, such as an ROP-qualified compliance officer, were assigned significant supervisory responsibilities over options accounts. However, in almost half of the firms surveyed by the Options Study, the SROP was not the firm's chief compliance officer, nor was the firm's chief compliance officer ROP-qualified.

In more than one quarter of the industry group sample, no senior official of the firm with options expertise had primary options compliance responsibilities, since the SROP was involved in his firm's options marketing effort, and the chief compliance officer was not ROP-qualified. In many of these firms, not a single home office compliance employee was ROP-qualified.

Having ROP-qualified individuals supervise options accounts at the home office level is less important if the firm's branch office managers are required to be ROPs. As noted above, however, only a little more than one quarter of the firms in the industry group sample now require their branch office managers to be so qualified. And almost one quarter of the responding firms (1) do not require branch office managers to be ROP-qualified; (2) do not have any ROP-qualified home office compliance personnel; and (3) assign to their SROP significant sales functions. To ensure sound options selling practices by the firm and its registered representatives, a policy-level compliance officer is needed at a firm's headquarters office to lead the program of supervising — not promoting — the firm's options business.

Accordingly, the Options Study recommends:

THE RULES OF THE SELF-REGULATORY ORGANIZATIONS SHOULD BE AMENDED TO REQUIRE THAT BROKERAGE FIRMS ASSIGN AT LEAST ONE HIGH RANKING PERSON WHO IS ROP-QUALIFIED TO PERFORM, OR TO DIRECTLY SUPERVISE, HOME OFFICE COMPLIANCE PROCEDURES RELATING TO OPTIONS. THE RULES SHOULD PROVIDE THAT, ABSENT A CLEAR SHOWING OF COMPELLING CIRCUMSTANCES, THIS PERSON HAVE NO SALES FUNCTIONS, DIRECT OR INDIRECT, RELATING TO OPTIONS OR OTHERWISE.

C. SUITABILITY

1. Introduction

During 1978, the Commission charged a major broker-dealer firm and several of its employees with violations of the anti-fraud provisions of the Federal securities laws in connection with the options selling activities of several of the firm's registered representatives. One team of registered representatives from this firm had persuaded its customers to engage in a program consisting of large-scale writing of uncovered options that were near-the-money, an extremely risky form of options trading activity. As outlined below, many of these customers did not have the financial means, sophistication, or investment objectives to justify exposure of a substantial portion of their assets to an uncovered writing program:

- . Customer A — a retired minister in his early 80's. He had an annual income of between \$10,000 and \$25,000 and a net worth of \$25,000 to \$50,000. His recorded investment objectives were dividend income and "additional income from sale of uncovered options." There was evidence that he was mentally unstable. He invested \$30,500 and lost \$23,700 in six weeks.
- . Customer B — an unemployed widow. She had an annual income of under \$10,000 and a net worth of approximately \$85,000, and relied on the expected income from her options account to meet her living expenses. Her prior investment experience consisted of mutual fund purchases, blue chip stocks, and a small amount of covered writing. She placed stock worth \$22,000 into the account and lost \$19,000 in six months.
- . Customer C — a retired post office worker. He had an annual income of approximately \$10,500 and a net worth of less than \$50,000. He invested \$16,700 and lost \$8,600 in three weeks.
- . Customer D — a computer designer. He had an annual income of \$25,000 and less than \$25,000 in estimated net worth and lost nearly all of his \$10,770 options investment.

- . Customer E — a college student. She needed income from her investment to complete her college education. She had a joint account with her father, a marketing representative, whose job took him out of the country for extended periods of time. The pair suffered a total loss of their \$25,000 joint account in one and a half months.

- . Customer F — a customer, with a severe heart condition whose objectives and investment experience were conservative. He transferred into his options account a portfolio consisting of investments in conservative stocks and an income-oriented mutual fund. The customer lost \$9,000 of the \$14,000 invested in two months.

These examples illustrate a major regulatory concern which has developed from listed options trading -- options trading is unsuitable for many of the public customers who engage in it. The Options Study found, throughout its investigation, numerous customers who had been solicited for listed options trading even though, by any reasonable standards, they had neither the sophistication to understand, nor the financial resources to bear, the risks they were undertaking.

None of the customers in the cases above satisfied the suitability standards of the self-regulatory organizations with regard to uncovered options trading; none of them even satisfied the brokerage firm's own minimum liquid asset and annual income requirements for customers who engage in risky options trading. The firm's general warning to its registered representatives against involving widows, senior citizens, and other classes of conservative investors in the more speculative types of options strategies was to no avail.

A number of factors contributed to the failure of this brokerage firm to protect the interests of its customers. The registered representatives involved were untrained, unscrupulous and unsupervised; the firm overemphasized commission revenue production; the local and home office supervisors were either unwilling or unable to supervise properly registered representatives selling options. These problems could not have occurred without serious flaws in the firm's suitability control procedures.

2. The Suitability Doctrine

The doctrine that a securities recommendation must not be unsuitable for a customer in light of his financial resources and investment objectives is a key element in a broker-dealer's obligation to deal fairly with its customers. The doctrine requires that a broker-dealer and its registered representatives recommend for the firm's customers only those securities transactions which they reasonably believe are suitable in light of the customer's financial situation and needs. ^{15/} The suitability requirement does not attempt to make a registered representative, or the brokerage firm for which he works, an insurer of favorable investment performance. It does, however, obligate the brokerage firm and registered representative to make sure that any recommendations made are done so with the customer's interests and characteristics uppermost in mind. As such, the doctrine, and the

^{15/} See generally R. MUNDHEIM, Professional Responsibility of Broker-Dealers: The Suitability Doctrine, 1965 DUKE L.J. 445 (1965) [hereinafter cited as MUNDHEIM]; N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS AND SECURITIES MARKETS (1977), ¶ 2.08 [hereinafter cited as WOLFSON].