- One registered representative promised some prospective clients between 10 and 500 percent return on options investments and other prospective customers "fantastic" returns with "minimal risk". After fifteen months of trading, his thirteen most active customer accounts had all experienced losses, ranging from 13 to 74 percent of the money invested.

b. Annualized rates of return

When a return on an amount invested for either less or more than a year is expressed in terms of a yearly rate, it is said to be "annualized." For example, an investment which results in a 5 percent return in four months is said to yield 15 percent on an annualized basis. The expression "annualized basis" here means that if the same money were invested at the same rate of return for the whole year, the return would equal 15 percent of the money invested.

However, since the life of any listed option is nine months or less, one cannot assume that funds invested in listed options can be reinvested at the same rate of return three, six, or nine months later. Interest rates, transaction costs and, of course, premium levels are all subject to change. Therefore, any annualized rate of return relating to options is misleading if the basis for the extrapolation is not disclosed.

To take an extreme hypothetical example, the purchase of an out-of-the-money call option for 50 cents at the beginning of a month and the sale of the option for $1.00 at the end of the month could yield a 100 percent return on investment (disregarding all transaction costs).

However, to tell the investor that this transaction would yield 1,200 percent on an annualized basis could be very misleading unless the customer were also told of the impact of transaction costs and of the virtual impossibility that this trade could be executed twelve consecutive times in a similarly profitable manner.

For these reasons, some professionals in the industry view the practice of expressing options investments in annualized terms as inherently fraudulent or, at best, meaningless. Other professionals argue that annualized rates of return are the only way that an investor can easily measure and compare the profitability of an options investment to another investment opportunity. For instance, the yield on bank savings accounts, treasury bills and other debt instruments is usually expressed in annualized terms. Some options professionals believe that the competitive pressure from these other investment opportunities mandates the use of annualized returns to describe options transactions or strategies. One options salesman stated the competitive realities succinctly: "...to get the business, you have to say something [regarding rates of return]."

Whatever the merits of annualization, the use of annualized returns to describe the profitability of proposed options transactions, without disclosure of all underlying assumptions, is misleading to investors. One brokerage firm recently attempted to deal with the problem of such disclosure by disseminating to its branch managers a memorandum which suggested that the following admonition be given to customers whenever annualized rates were mentioned:

> Use of annualized rates of return makes it easier to compare different strategies involving different durations. It does not imply, however, that the investor will realize the described rate over a period as great as one year or that transactions entered into after the suggested investment position is liquidated would produce comparable rates of return.

This same firm has also included on its options worksheet a disclaimer concerning the likelihood that a specific trade would achieve the annualized rate set out on the worksheet.

Not all disclaimers, however, adequately inform customers of the assumptions implicit in annualization. In fact, some serve to further mislead investors by disclaiming unrealistic assumptions:

> Our mathematical models suggest positions that should normally appreciate between 10% and 25% annually. These rates cannot, of course, be guaranteed. However, unless the particular corporation appears to be going bankrupt or a national catastrophe occurs, there is normally a very small risk.

c. <u>Other problems with the use of rates of return</u>

In addition to being exaggerated and misleading, annualized rate of return figures, when used in promotional materials for options, are troublesome for other reasons.

(1) <u>Misleading calculations</u>

Since the rate of return figure is frequently the major device used to gain the interest of customers in various types of promotional materials, the computation which establishes the return figure should be done correctly. However, the Options Study has reviewed several promotional documents where the figures simply were wrong. Even the CBOE reference manual, described by the CBOE as a "valuable tool for the registered representative as he endeavors to present the option concept to the investment public", contains a prominent rate of return computation which is incorrect.

The CBOE attempted to show why an investor contemplating a $5,000 stock investment should consider a combined investment in both options and short-term money market instruments, where $500 would be committed to options and the remaining $4,500 to the short-term money market paper. The error resulted because the investor's return on the entire $5,000 investment was expressed instead as a percentage of the $500 committed to options. The CBOE's example is as follows:

> [A]n AT 50 call option might have been purchased six months prior to expiration, when the stock was at 50 and the option was selling for 5. At the same time, the remaining funds [$4,475] might have been invested in a short-term money market investment yielding 5%. If, at expiration, [six months later] the stock had appreciated in value to 60, the option might be selling at its intrinsic value of 10.

Cost:

$ 500	Option premium
+ 25	Commission
$ 525	Total cost

Proceeds:

$1,000	Sale of option
- 40	Commission
$ 960	Total option proceeds
+ 112	5% on $4,475 invested
$1,072	Total proceeds
$1,072	Proceeds
- 525	Cost
$ 547	Net profit (104% on the original investment)

In reality, the "net profit" of $547 represents not 104 percent, but less than 11 percent of the total original investment of $5,000.

(2) Failure to include transaction costs

The accuracy of any rate of return figure is significantly affected by brokerage commissions, interest charges, and other transaction costs. Yet, since omission of these figures simplifies the computations, promotional literature, even that produced by one of the options exchanges, does not always include transaction costs when calculating rates of return. To ignore these costs, however, can result in rate of return computations misleading to the public investor.

(3) Distorted presentations

Another practice in the industry is to portray rates of return in percentage figures (which generally are more impressive than dollar figures) for gains, but almost never to portray losses in percentage figures. Potential losses are discussed, if at all, in absolute dollar figures. To give a hypothetical example, if an investor bought an option for 50 cents, and sold the option for $1.00, most promotional literature would call his result a 100 percent return. However, if the investor lost the 50 cents, that is, if the option became worthless, the literature would not say that the investor had lost 100 percent of his investment. Instead, the investor would be said to have suffered a loss of "only 50 cents" or a loss "limited to 50 cents."

The "strategies" chapter of the AMEX's 1977 "A Guide to Listed Options" exemplifies the practice of expressing gains as percentages but losses in dollar figures. Eighteen times in that chapter a computation of gains is offered. In ten of those instances, gains are expressed in percentage terms; in eight of those instances gains are expressed in absolute dollar terms only. On the other hand, while the possibility of loss is mentioned thirty times in the same chapter, only once are losses expressed as a percentage of investment, with losses expressed in absolute dollar terms twenty-nine times.

3. <u>Predictions, Promises and Guarantees</u>

a. <u>Predictions without a reasonable basis</u>

The use of exaggerated rate of return figures to promote and sell options is often accompanied by actual or subtle suggestions that the designated return is a predictable result of a proposed options investment.

The Commission has long held that a registered representative must have a reasonable basis for any recommendation he makes or opinion he expresses about a security since "groundless opinions come within the ambit of false and misleading statements prohibited by the securities laws." 31/ Predictions of earnings for speculative securities have been considered inherently misleading unless accompanied by "full disclosure of both the facts upon which they are based and the attendant uncertainties." 32/

The Options Study has encountered numerous instances in which a registered representative's opinion as to the anticipated rate of return for an options transaction or strategy, although expressed with the authority and conviction of a prediction, had no reasonable basis. When asked to justify their opinions, registered representatives sometimes admit that they have no basis for the opinion or else respond with only vague generalities. One registered representative indicated that her "objective" of achieving a "20-30% consistent annual return" for customers in options trading was based upon her knowledge of a seven-year market cycle. However, she could not explain how to relate this cycle to the listed options markets which has existed only since 1973. Another registered

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31/ Alexander Reid & Co., 40 SEC 986 (1962).

32/ Richard J. Buck & Co., 43 SEC 998, 1006 (1968), aff'd sub nom. Hanley v. SEC, 415 F.2d 589 (2d Cir. 1969).

representative told his customers that they could expect between 15 and 20 percent annualized returns with minimal risks. Although he based this prediction upon his "general feeling for the performance of accounts" he had seen, he could not specifically identify for Commission investigators any account in which such returns had been achieved. One registered representative testified that he felt his representation to customers of a 25 percent return in options was "conservative" based upon statements by the firm's options coordinator that certain accounts in the firm had returned as high as 40 percent. Another registered representative solicited options customers with representations of returns as high as 15 percent, although he admitted that he had never seen an options account return that much.

One registered representative testified that he solicited potential options customers by presenting a 25 percent yearly rate of return as a target which he hoped to achieve through options. Several of his customers claimed that he had promised them even larger annual returns, in some cases ranging up to 500 percent. The Commission's staff analyzed this registered representative's customer options accounts for the period covering the bulk of his options trading activity and found that only three of 40 accounts were profitable, that customer losses aggregated $292,000, and that the average account lost 24 percent of the equity invested, with commissions comprising 67 percent of those losses.

Similarly, by using pseudo-scientific articles and a newsletter, one broker-advisor team gave potential customers the impression that it could scientifically predict results for customers participating in the team's options trading program. The team claimed that no account managed by the advisor had ever lost money. In addition, a published article authored by the advisor, which claimed that accounts under management had averaged more than a 10 percent return annually over the past several years, was reprinted and distributed to potential clients. When asked for the basis of the 10 percent figure used in this article, the advisor could only respond:

> It is common and accepted practice in this [academic] society and others to publish figures and not too extensive computations relating to those figures.

Later, the advisor admitted having no records to substantiate his claims concerning the profitability of clients' options accounts except for records of one calendar quarter during which 21 of the 49 managed accounts actually had experienced a decrease in net asset value.

Another team of salesmen told their customers that they were able to predict the profitability of proposed options transactions by means of a "scientific system" which they compared to short-term weather forecasting. Their profitability forecasts, however, were cloudy and invariably wrong.

b. Objective versus guarantee

The emphasis in many of the materials used to promote and sell options is on achieving an attractive rate of return with a minimum of risk. Given these optimistic promotional efforts, statements made to customers by their registered representatives about the profitability of options often mislead investors into believing a risk-free return is predicted, promised, or even guaranteed.

Some investors claim to have been told that they would "almost definitely" receive a favorable rate of return from options trading; others claim that specific returns have been guaranteed outright. Even when representations are phrased as "objectives", "goals" or reasonable targets for profitability, investors often believe that they have been promised a particular rate of return. Investors typically are told that options have a profit potential of 12 percent to 14 percent; that an options program can produce "a 20-30% consistent annual return"; that options trading is "expected to produce" a given rate of return; or that certain options trading strategies or programs are "lucrative". In one instance, an investor was told that options trading is the same as having "someone throwing quarters at you."

When representations of this type are coupled with statements which minimize the risk of loss, the investor can understandably believe that he is being promised a favorable rate of return.

Some registered representatives have told customers that options were a "guaranteed way to make good" and that the customer "couldn't lose." One registered representative claimed he had a "foolproof formula", complete with equations, which demonstrated how a customer could make "large profits of 35 percent without possibility of loss."

Although registered representatives usually deny promising any customer a profit, the Options Study has identified several situations in which options customers have been given outright guarantees. For instance, one registered representative guaranteed to his customer, in writing, that the customer's losses would not exceed $2,000 from trading options in three months. He renewed this guarantee each three months for a nine month period. The registered representative signed his guarantee on behalf of the brokerage firm, telling his customer that the firm would honor the written guarantee. The customer incurred substantial losses and the guarantee proved worthless. The same registered representative offered a comparable guarantee to another of his customers. Similarly, another registered representative provided a customer with a written guarantee which assured the customer a 50 percent return in only four months. In still another instance, a registered representative deposited funds in a customer's account as part of an arrangement with the customer to guarantee the customer against loss. On occasion, the Commission's examiners have also found indications that certain registered representatives selling options were guaranteeing customers against unprofitable transactions by regularly transferring such transactions from customer accounts to the firm's error account. Guaranteeing customer transactions against loss is expressly prohibited by exchange rules. 33/

4. Controls

The following table sets out firm policies of the industry group sample concerning price predictions, predictions of return on investment and guarantees:

	YES	NO	NO ANSWER
Firm has a policy applicable to options prohibiting sales persons making price predictions to customers	73%	25%	2%
Firm has a policy applicable to options prohibiting sales persons making predictions of return on investment to customers	62%	38%	—
Firm has a policy applicable to options prohibiting sales persons making guarantees of return on investment to customers	98%	2%	—

33/ E.g., Rule 9.18, CBOE GUIDE (CCH) ¶ 2318.

To monitor these policies, most firms review correspondence and customer complaints and rely on the integrity and professionalism of their sales force. Such controls have not been effective in preventing abuse or in protecting investors.

Of the firms in the industry group sample, 52 percent allow salespersons to use annualized rates of return when discussing the profitability of options transactions with options customers. Although many of these firms discourage or limit the use of annualized returns in some manner, most have no effective means for monitoring compliance with their restrictions. 34/

The Options Study recommends:

> THE SELF-REGULATORY ORGANIZATIONS SHOULD AMEND THEIR OPTIONS RULES TO REQUIRE (1) THAT WHENEVER RATES OF RETURN ARE CALCULATED FOR DISCLOSURE TO INVESTORS, ALL RELEVANT COSTS MUST BE INCLUDED IN THE COMPUTATION; AND (2) THAT WHENEVER ANNUALIZED RETURNS ARE USED TO EXPRESS THE PROFITABILITY OF AN OPTIONS TRANSACTION, ALL MATERIAL ASSUMPTIONS IN THE PROCESS OF ANNUALIZING MUST BE DISCLOSED TO THE INVESTOR AND A WRITTEN RECORD OF ANY RATE QUOTED TO A CUSTOMER MUST BE KEPT.

34/ The self-regulatory organizations also have regulations which attempt to circumscribe the use of rates of return by brokerage firms in advertising and sales literature. The industry's recently promulgated uniform guidelines for advertising and sales literature are a beginning in the regulatory effort to control some of the problems arising from the use of annualized rates of return to describe the profitability of options transactions. These guidelines generally provide that annualized rates of return, when used, must be accompanied by a description of their means of calculation as well as the assumptions underlying the annualization process.

F. PROMOTING OPTIONS - SPECIFIC METHODS.

1. Advertisements and Sales Literature

Advertisements and sales literature generally represent a brokerage firm's most formal and "official" efforts at promoting and informing customers about options. Unlike worksheets, performance reports and other ad hoc promotional efforts of individual branch offices or salespersons, advertisements and sales literature are usually produced by the firm's headquarters office and bear the official stamp of approval from management.

The Options Study's review of a sampling of advertisements and sales literature revealed that promotional styles differ among firms, and even within the same firm from time to time, and that these styles vary from low-key to aggressive. The materials seen by the Options Study primarily were those filed with the self-regulatory organizations for review or approval. Although many of these materials seemed unobjectionable, certain problems were identified. These problems continue to be of concern since some salespersons and firms sometimes neglect to file advertising materials for review as required by exchange rules. 35/

a. Promises of attractive returns

As noted earlier, the holding out of attractive returns on investment is a recurring theme in promotional programs of brokerage firms. As also

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35/ *E.g.*, Rule 9.21, CBOE GUIDE (CCH) ¶ 2321; Rule 483, 2 ASE GUIDE (CCH) ¶ 9494. See Chapter VI.

noted, customers often believe that they have been "promised" these attractive returns if they decide to invest in options. The Options Study has found that promises of successful results are implicit in many of the advertising and sales literature documents it reviewed. These "promises" are particularly significant because they are conveyed to a customer, not by salespersons, but through materials issued by the firm itself. If these materials make exaggerated or unrealistic claims about options, these claims will not only mislead the public directly, but they also will indicate to the firm's sales force that the firm approves of similarly exaggerated claims in presentations made by registered representatives in direct contact with customers.

The following are a few examples from advertisements or sales literature reviewed by the Options Study which seem to make or imply promises that favorable results will usually flow from options trading:

- "Would you be interested in receiving 15 to 20% annual income from the stocks you now own?" March 1976. [The CBOE changed "receiving 15-20%" to "up to 15-20%". A year later, on reconsideration, the CBOE required the firm to delete the reference to specific numbers and to simply use the language "an attractive return."]

- "Don't expect to triple your money using options . . . 15% is our goal." April 1976. [Large bold-print advertisement, withdrawn after several months use when the CBOE retracted its approval.]

- "Tempted? Come on in. Everybody loves a 10%-12% yield." September, 1977. [Promotional Letter.]

- "... why settle for 9%, if there is the opportunity to achieve significantly more with limited risk?" [Promotional letter to "qualified clients and prospects," to be accompanied by an OCC Prospectus.] February, 1978.

- "If your firm has a qualified pension plan of any type, for the benefit of you or your employees, I would like the opportunity to outline an investment concept that is an alternative to fixed income securities with a substantially greater percent return. The main features of this investment are:

  - Short term market exposure, less than 9 months.
  - Liquidity
  - Returns of 10-16% on net investment...." [Promotional letter.] March, 1977.

Many of these advertisements emphasize the possible rewards of options trading without adequately discussing the corresponding risks, in clear contravention of exchange rules which require a balanced presentation. 36/

b. Touting the "Expert"

Another promotional theme found in advertisements and sales literature which is somewhat related to the problem of promises and predictions, is the touting of the firm's in-house options "expert" or expertise. A number of firms also claim to have a special formula or computer program designed to help the options "expert" achieve favorable results for options customers. For example, one firm has an "Oasis-5 stock sensitivity program"; another has the "Peroni system". Another firm attempted to promote one of its employees as a "well-known options advisor to CBOE, AMEX, member of the Board of Directors of the Options Clearing Corporation....", but

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36/ *E.g.*, Rule 9.21.01.II.A, CBOE GUIDE (CCH) ¶ 2321.

was forced to modify the language on the insistence of the options exchanges. And one firm claims to have "one of the most sophisticated options programs in the country."

These claims are easily made because, in general, brokerage firms have not been required to document the success of their programs or formulas, or to demonstrate the expertise of their "expert". Even the ROP examination is not designed to do more than test for a minimum basic understanding of the mechanics of listed options.

Since a common complaint of options customers is that they did not understand options, and were induced to invest in options only after receiving assurances that they could rely on the proclaimed expertise and special capabilities of a brokerage firm and its options experts, the Options Study is particularly concerned about management-sanctioned advertisements which create an impression that an options "expert" or options expertise is indeed available at the firm.

Therefore, the Options Study recommends:

> THE RULES OF THE SELF-REGULATORY ORGANIZATIONS SHOULD BE AMENDED TO REQUIRE THAT MEMBER FIRMS MAKE AVAILABLE FOR PUBLIC INSPECTION UNEQUIVOCAL AND COMPREHENSIVE EVIDENCE TO SUPPORT ANY CLAIMS MADE ON BEHALF OF OPTIONS "PROGRAMS" OR THE OPTIONS "EXPERTISE" OF SALESPERSONS.

c. Flamboyant language

The complexity of options as an investment vehicle makes them an inappropriate subject for aggressive or "hard sell" techniques. Yet, the Options Study found a disturbing number of options advertisements of questionable taste and veracity. While issues of tone and taste may be matters of individual preference, the rules of the options exchanges plainly prohibit use of promotional materials which are misleading or which fail "to meet general standards of good taste and judgment common to the securities industry." 37/ The following are a few examples of promotional statements which seem to have both qualities:

- "Do you want more mileage from your commission dollars?" March 1976.

- "Would you like to buy stock at an effective price below current market using Options?" March 1976.

- "Learn how you may buy stocks below the current market price – and also be paid a premium." October 1977. [The CBOE changed "how you may buy" to "how it is possible to buy" and struck out references to a premium.]

- "How to make money by buying and selling options on the same stock at the same price." October 1977. [The CBOE changed "How to" to "Learn how you might...."]

There is a magical tone to these statements. In fact, the last example above continued: "No we're not pulling your leg." Another firm's proposed advertisement began "Believe it or not..." If materials produced by the brokerage firm foster the impression that options work in mysterious but marvelous ways, the customer is left either without information, or worse, with misinformation about options.

37/ See, e.g., Rule 9.21(b)(iii), CBOE GUIDE (CCH) ¶ 2321. The other options exchanges have similar rules.

2. Seminars

Seminars are a popular technique for attracting and educating options customers. Firms use various labels to describe seminars -- e.g. "clinic" or "forum" -- and some seminars are purportedly designed to reach only "sophisticated" or "experienced" options investors. A few firms occasionally go so far as to charge a fee for a seminar, which is sometimes then labeled a "course."

In most cases, brokerage firms do not provide the texts of options seminars to the options exchanges in advance, since advance review of materials is required only for mass media materials. However, mass media advertisements for options seminars must be cleared by the exchanges, and the content of the seminars must conform to general exchange rules which require truthfulness and good taste in communications with the public.

Because seminars are advertised as primarily educational -- and not promotional -- meetings, they evoke an image of a balanced presentation of the advantages and disadvantages of using options in investment programs. The texts of the few seminars that have been reviewed by the Options Study, however, reveal that seminars can be far from the balanced presentations they often purport to be, and rather, may be simply another means used by a firm for attracting options customers. As such, they contain the same promotional bias that characterizes other forms of advertising.

The presentation of one national broker-dealer firm's series of seminars, featuring the "[Name] System" of options investment, exemplifies this problem. This "system" -- described as a "high yield; low risk investment concept" — was essentially a covered options writing program to which the "[Name] System" was supposed to provide "added protection and profit potential". Audiences were told that the system featured:

- "Risk reduction"
- "Earning the time premium"
- "Management of the portfolio"
- "Net yield of 18-20 percent"

The audience was further informed that a properly managed covered writing program would increase the odds of investment success by 3 to 1 over the investor who remained a "non-writer". These odds were derived from a "computer analysis" of stock market performance over a twelve year period."

To reinforce the audience's belief in the success of the "system", an example of a profitable covered writing investment was described, complete with attractive annualized rates of return on investment.
The audience was told that, by carefully choosing the stock and monitoring the stock-option position, a writer could enjoy attractive gains in either an up or down market. All examples seem to have been selected carefully to ensure a favorable and predictable result.

The "[Name] System" seminars were conducted from mid-1976 until February 1978, when the text of the presentation finally came to the attention of the CBOE. The CBOE promptly objected to the contents, finding that the presentation was "unbalanced in terms of risk and potential reward," and that it:

- . fail[ed] to address the subject of suitability;
- . frequently quot[ed] ... rather inflated theoretically attainable annualized rates of return, [without making any] attempt to explain how the figures were derived;
- . contain[ed] implied guarantees and other promissory language.

The broker-dealer firm was thus forced to revise the text of the seminar two years after the seminar was first presented to the public. The revisions were not finally approved by the CBOE until April 1978.

Another firm's seminar script reviewed by the Options Study suggested that the "harsh choice" facing an investor who confronted the "bad news" of inflation (depicted as a large fierce monster devouring money) was to "either cut back on living standards or look for new ways to boost [his] investment yield past that 8.2% inflation line." The "good news" was the availability of a "little-known way to possibly out-race inflation <u>without</u> taking on a lot of risk ... " And the way was: "<u>option writing for more income now</u>." (Emphasis in original.)

The presentation used evocative words designed to promote options. The hypothetical stock chosen for purchase in the covered writing example was called "Superior Company", and the investor "who didn't believe in options" was named "Mr. Lackluster". (The AMEX insisted that the name be changed to "Mr. Jones".) The first covered writing example provided the investor with a 14 percent annualized return and subsequent hypothetical examples showed the options writer almost always faring better than the mere stock purchaser. The one exception occurred when Superior's stock "sho[t] up" beyond the strike price. In that case, "the buyer would [have] exercise[d] his option and [the covered writer] would [have] miss[ed] out on all the gain above the striking price ...." However, the covered writer "would come out ahead in the three out of four situations we've been seeing most often in the market."

Brokerage firms unquestionably have the right to promote the sale of securities — including options — through various promotional devices, including seminars. However, firms should not be permitted to engage in sales promotions under the guise of offering an educational service.

Accordingly, the Options Study recommends:

(1) THE RULES OF THE SELF-REGULATORY ORGANIZATIONS SHOULD BE AMENDED TO REQUIRE THAT WHEN MEMBER FIRMS USE SEMINARS TO PROMOTE OPTIONS, THEY MAKE THE FOLLOWING DISCLOSURES TO THOSE ATTENDING:

—IF THE "LECTURER" IN THE SEMINAR IS A BROKERAGE FIRM EMPLOYEE COMPENSATED IN WHOLE OR PART BY COMMISSIONS, AND IS USING THE SEMINAR TECHNIQUE TO ATTRACT CUSTOMERS, HIS FINANCIAL INTEREST IN THE ACQUISTION OF CUSTOMERS FROM THE AUDIENCE SHOULD BE DISCLOSED;

—IF A "PROGRAM" OR "SYSTEM" DESCRIBED IN THE SEMINAR IS ALREADY IN USE, THE CUMULATIVE EXPERIENCE OF THE PROGRAM'S PARTICIPANTS SHOULD BE FULLY DISCLOSED AND DOCUMENTED, AND THE AUDIENCE SHOULD BE WARNED THAT PAST RESULTS ARE NO MEASURE OF FUTURE PERFORMANCE;

—IF THE PROGRAM IS TOO NEW TO HAVE A PERFORMANCE HISTORY, THE AUDIENCE SHOULD BE FULLY APPRISED OF THE UNTRIED NATURE OF THE PROGRAM.

(2) SELF-REGULATORY ORGANIZATIONS SHOULD DEVELOP A PROGRAM IN WHICH SURPRISE ATTENDANCE AT SEMINARS FORMS PART OF THEIR OVERALL INSPECTION PROGRAM RELATING TO OPTIONS SALES PRACTICES.

3. Worksheets and Performance Reports

Worksheets portray the profit potential of proposed options transactions and are widely used throughout the securities industry to depict the potential risks and returns of proposed transactions to customers. They are used both in face-to-face sales presentations between customers and registered representatives and are sometimes sent to customers to solicit their participation in particular options transactions.

Worksheets can be adapted to portray the risk and return possibilities of most types of options transactions, but the Options Study found them used most frequently in conjunction with recommendations concerning covered call writing strategies. A typical worksheet for a covered call writing transaction would show the maximum potential returns available to an investor if the underlying stock were called away from the investor (that is, if the holder of the option exercised the option), and if the stock were not called away (that is, if the option were not exercised). Some covered writing worksheets also include a calculation of a "break-even point" for the proposed transaction.

Some firms prohibit the use of worksheets, while other firms limit their use. The following table sets out the policies of firms in the industry group sample with regard to showing or sending worksheets to customers.

	Existing Customers	Potential Customers
Registered representatives may show worksheets to:	72%	63%
Registered representatives may send worksheets to:	61%	53%

As distinguished from worksheets, which present for options customers the profit of potential transactions, "performance reports" purport to analyze the results of actual options transactions. Two types of options performance reports are commonly used in the brokerage industry: (1) a report of realized or unrealized gain or loss in a customer's account resulting from a single options transaction or series of options transactions; and (2) a report containing a similar analysis over a specific time period of the customer's entire portfolio or of his options portfolio alone. The typical options performance report is generally a statement of profit and loss. It may serve to supplement, and if properly done, help translate, the periodic customer account statements which are often difficult to understand.

In addition to serving as supplements to the periodic account statements, performance reports may be used as selling documents, and shown to potential customers to solicit new options business. The successful experience of actual customers can be an extremely effective inducement to potential customers considering options as an investment.

The table below sets out the policies of firms in the industry group sample with regard to use of performance reports:

	Owner of Account	Prospective Customers
Allow computer generated reports to be shown to:	28%	5%
Allow reports other than computer generated to be shown to:	54%	7%

Thirty-eight percent of the industry group sample prohibits the use of performance reports by registered representatives altogether.