

**DAVIS POLK & WARDWELL**

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Date: May 23, 2008  
To: Interested Persons  
Re: FINRA Updates Options Rules, Requiring Firms to Modify Compliance and Supervisory Policies and Procedures

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The Financial Industry Regulatory Authority, Inc. (“**FINRA**”) has recently made, and proposed, a number of changes to the National Association of Securities Dealers, Inc.’s (“**NASD**”) rules concerning options. Although these changes will generally promote operational flexibility and reduce redundancy in the design of supervisory programs, they will require significant amendments to firms’ options compliance and supervisory procedures.

There are two principal sets of changes. The first (the “**Supervision Amendment**”)<sup>1</sup> modifies FINRA’s options supervision rules, and replaces the requirement that firms having customer option businesses designate Compliance Registered Options Principals (“**CROPs**”) and Supervisory Registered Options Principals (“**SROPs**”) with a requirement that certain compliance and supervisory functions be carried out by a Registered Options and Security Futures Principal (“**ROFSP**”) designated in the firm’s written procedures. The second (the “**Options Communications Amendment**”)<sup>2</sup> will, if adopted, modify the procedures associated with options-related communications.<sup>3</sup>

The Supervision Amendment was approved by the Securities and Exchange Commission (the “**SEC**”) on May 5, 2008, and becomes effective June 23, 2008.<sup>4</sup> The Options Communications Amendment was published by the SEC

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<sup>1</sup> Securities Exchange Act Release No. 34-57775 (May 5, 2008), 73 FR 26453 (May 9, 2008) (Approval Order for File No. SR-FINRA-2007-035). The Supervision Amendment essentially mirrors a prior rule change implemented by the Chicago Board Options Exchange. See Securities Exchange Act Release No. 34-56971 (December 14, 2007), 72 FR 72804 (December 21, 2007) (Approval Order for File No. SR-CBOE-2007-106).

<sup>2</sup> Securities Exchange Act Release No. 57720 (April 25, 2008), 73 FR 24332 (May 5, 2008) (Notice for File No. SR-FINRA-2008-013).

<sup>3</sup> Other recent options-related rule changes and proposals include the permanent approval of a long-standing “pilot” program for options position limits. See FINRA Regulatory Notice 08-10 (March 2008), and a proposal (which has not yet been published by the SEC for public comment) to delete certain New York Stock Exchange (“**NYSE**”) option rules as part of a larger “rules harmonization filing.” SR-FINRA-2008-014 (filed April 14, 2008).

<sup>4</sup> FINRA Regulatory Notice 08-28 (May 2008).

for a public comment period but has not been approved by the SEC. If the Options Communications Amendment is approved, FINRA has proposed that it will become effective 90 days following the publication of a Regulatory Notice announcing the amendment.

## Summary of Rule Changes and Impact on Member Firms

### A. Supervision Amendment

Until now, NASD rules regarding options supervision have required member firms engaged in options activities with public customers to maintain a special supervisory program for options activities, to have at least one ROSFP and to designate a SROP and a CROP. The NASD Rules also allocate specific supervisory and compliance functions to the SROP and CROP, respectively. CROPs have been required to approve in advance all advertisements, sales literature, and educational material issued by a member pertaining to options and to maintain records of such material. The SROP's role has, among other things, been to approve customer accounts that do not meet specific criteria and standards for writing uncovered short options transactions and the acceptance of discretionary accounts. The main elements of the Supervision Amendment are:

- *Requirement for Separate Options Supervisory System Eliminated.* The current requirement that member firms develop and implement a separate written program for supervision of its customer options accounts and orders is eliminated. Instead, members must ensure that their overall written supervisory systems, policies and procedures adequately address the members' public customer options business.<sup>5</sup>
- *SROP and CROP Designations Eliminated.* The SROP and CROP designations will no longer be used. Firms will still be obligated to designate registered principal(s), who must be ROSFPs, to supervise their options activities.
- *ROSFP Must Approve Certain Communications and Uncovered Short Options Writing.* Options Advertisements, sales literature and educational material must be approved in advance by an ROSFP who is designated by the member's written supervisory procedures.<sup>6</sup> In addition, the firm must maintain copies of the material, together with the names of the persons who prepared and approved it, and in the case of sales literature, the source of any

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<sup>5</sup> NASD Rules 3010, 3012 and 3013 address a member's duty to implement and maintain written supervisory procedures and a supervisory control system.

<sup>6</sup> As discussed below, the definition of what constitutes "sales literature" with regard to options is the subject of the proposed Options Communications Amendment.

recommendations. Members are also required to designate an ROSFP as responsible for approving customer accounts that do not meet the specific criteria and standards for writing uncovered short option transactions.

- *Discretionary Accounts.* Members must now designate a specific ROSFP to review discretionary accounts. A second ROSFP, other than the ROSFP who accepts the discretionary account, must review the acceptance of each discretionary account to determine that the accepting ROSFP had a reasonable basis for believing that that customer was able to understand and bear the risk of the strategies or transactions proposed, and must maintain a record of the basis for the determination. Discretionary accounts should also receive frequent supervisory review by an ROSFP who is not exercising the discretionary authority over the account.<sup>7</sup> The discretionary account provisions are also amended to limit the discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite number of option contracts in a specific security shall be executed. The amended rule considers the authority to exercise time and price discretion to be in effect only until the end of the business day on which the customer granted such discretion, unless there is a contrary written instruction signed and dated by the customer.<sup>8</sup>

B. Options Communications Amendment

The Options Communications Amendment proposes to amend various definitions in NASD Rule 2220(a) to adopt the term “options communications” and to redefine how such material should be supervised by member organizations. The main elements of the Options Communications Amendment are:

- *Definition of Options Communications.* The provisions concerning communications subject to the supervision, content and (where applicable) filing provisions of NASD Rule 2220 are amended to adopt the term “options communications,” which consists of the categories “advertisement(s),” “sales literature,” “correspondence,”

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<sup>7</sup> In addition, firms that utilize computerized surveillance tools are no longer required to have discretionary options orders approved and initialed on the day of entry by a branch office manager or authorized ROSFP, and instead must ensure that discretionary orders receive frequent supervisory review by an ROSFP who is not exercising discretionary authority in accordance with the member’s written supervisory procedures. Members who do not use computerized surveillance tools for the frequent and appropriate review of discretionary activity must establish and implement procedures to require specific ROSFPs who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered.

<sup>8</sup> The limitation does not apply to time and price discretion exercised in an institutional account pursuant to valid Good-Till-Cancelled instructions issued on a “not held” basis.

“institutional sales material,” “public appearance(s),” and “independently prepared reprint(s).”<sup>9</sup> Each category of options communications (other than the term “public appearance(s)”) incorporates the corresponding definition contained in the NASD’s general communications rules, NASD Rules 2210 and 2211.<sup>10</sup>

- *Approval and Recordkeeping by ROSFP.* Most options communications will require the advance approval of an ROSFP designated by the member’s written supervisory procedures.<sup>11</sup> The designated ROSFP is not specifically required to review correspondence related to options unless it is distributed to 25 or more existing retail customers<sup>12</sup> within any 30 calendar-day period. However, all correspondence is subject to the provisions of NASD Rule 3010(d).<sup>13</sup>
- *Approval by FINRA.* In addition to the member’s options communications approval requirements, all advertisements, sales literature, and independently prepared reprints issued by a member concerning *standardized options* and used *prior to* the delivery of the applicable *current* options disclosure document (“**ODD**”) or prospectus must be submitted to FINRA’s Advertising Regulation

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<sup>9</sup> The previous version of Rule 2220(a) contained stand-alone definitions of the terms “advertisement,” “educational material,” and “sales literature” that were used specifically for the purposes of the rule. The Options Communications Amendment proposes to redefine the categories of “advertisement” and “sales literature” and removes the term “educational material.” Communications that would previously have been considered “educational material” would now be classified as either “advertisements” or “sales literature.”

<sup>10</sup> In addition, for the purposes of NASD Rule 2220, the amendments define the terms “existing retail customer,” “options,” and “options disclosure document” as those terms are defined in NASD Rules 2211 and 2860. A “public appearance” is any participation in a seminar, forum (including an interactive electronic forum), radio, television or print media interview, or other public speaking activity, or the writing of a print media article, concerning options.

<sup>11</sup> The proposed amendment NASD Rule 2220(b) will require an ROSFP to approve all “advertisements,” “sales literature (except completed worksheets),” and “independently prepared reprints,” and will require the member to establish appropriate written procedures to review “institutional sales material” concerning options.

<sup>12</sup> NASD Rule 2211(a)(4) defines an “existing retail customer” as “any person for whom the member or a clearing broker or dealer on behalf of the member carries an account, or who has an account with any registered investment company for which the member serves as principal underwriter, and who is not an institutional investor.”

<sup>13</sup> NASD Rule 3010(d) establishes the general obligations of members regarding supervision of correspondence. FINRA has recently published for member comment a proposal to amend (and renumber) Rule 3010(d). See FINRA Regulatory Notice 08-24 (May 2008).

Department (the “**Department**”) at least 10 calendar days in advance for approval.<sup>14</sup>

- *Standards Applicable to Standardized Options Communications.* Options communications regarding *standardized options* that are exempted under SEC Rule 238<sup>15</sup> under the Securities Act of 1933 (the “**Securities Act**”) used prior to ODD delivery now have various restrictions, including requirements pertaining to the description of the options discussed, contact information, and the use of projected performance figures. Options communications regarding options not exempted under SEC Rule 238 used prior to the delivery of a prospectus must conform to SEC Rule 134 or 134a under the Securities Act.<sup>16</sup>
- *General Standards for Options Communications.* The existing general standards relevant to options communications will have additional restrictions, including a prohibition on the use of cautionary statements or caveats that are not legible, misleading or inconsistent with the content of the options communications material. The general standards also restrict options communications (other than those constituting institutional sales material) that fail to include statements that options are not suitable to all investors.<sup>17</sup> In addition, options communications must include a statement that supporting documentation for any claims made within the document will be supplied upon request.<sup>18</sup> The standards for options communications also now allow for the use of projected performance figures and historical performance data, subject to certain conditions, provided that all such communications regarding standardized options are accompanied or preceded by the ODD.<sup>19</sup> With specific regard to the use of

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<sup>14</sup> Members are no longer required to submit options communications that pertain to nonstandardized options to the Department, but the Department may require a member to file some or all options communications related to non-standardized options.

<sup>15</sup> Standardized options are exempt under SEC Rule 238 if they are issued by a registered clearing agency and traded on a national securities exchange.

<sup>16</sup> SEC Rules 134 and 134a govern what types of communications and options materials will not be deemed to be a “prospectus” for the purposes of Section 10 of the Securities Act.

<sup>17</sup> The amendment also prohibits suggestions to the contrary.

<sup>18</sup> These two restrictions do not apply to institutional sales material, as previously defined.

<sup>19</sup> The restrictions on the use of projected or historical performance data include the mandate that all such data be presented fairly and accurately, with the parameters relating to such figures clearly established, and all relevant fees, costs and interest charges as applicable be

historical performance data, the existing restrictions on such data are expanded to require that all such options communications are accompanied or preceded by the ODD and that all relevant fees and daily margin obligations (as applicable) are disclosed and reflected in the performance.

### **Conclusion**

FINRA members engaged in customer options business should:

- Review their written supervisory and compliance procedures regarding the public customer options business and amend references to SROP and CROP functions, and ensure that specific ROSFPs are designated to review all options communications and discretionary accounts, and to approve customer accounts failing to meet the specific criteria for writing uncovered short option transactions.
- Review their policies and procedures regarding time and price discretion to conform such policies and procedures with FINRA's new guidelines on when such discretion expires and train associated persons as to these changes.
- Be aware of the potential changes regarding FINRA's options communications rules and ensure that the designated ROSFP(s) in charge of options communications are aware of the revised definitions and requirements pertaining to such communications.

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disclosed. With regard to historical performance data, an ROSFP must determine that the records and statistics are fairly presented and so initial the report.