

Regulatory Notice

08-28

Options Supervision Requirements

SEC Approves Amendments to Eliminate the Requirement for the Senior Registered and Compliance Registered Options Principals (SROP and CROP)

Effective Date: June 23, 2008

Executive Summary

Effective June 23, 2008, the requirement for separate designations of Senior Registered Options Principal and Compliance Registered Options Principal is eliminated and member firms are required to integrate the responsibility for supervision and compliance of their public customer options business into their overall supervisory and compliance programs.¹ The amendments to NASD Rules 1022, 2220 and 2860 are set forth in Attachment A of this *Notice*.

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104; or Kathryn M. Moore, Assistant General Counsel, OGC, at (202) 974-2974.

May 2008

Notice Type

- Rule Amendment

Suggested Routing

- Compliance
- Institutional
- Legal
- Operations
- Options
- Registration
- Senior Management

Key Topic(s)

- Compliance Registered Options Principal
- Discretionary Accounts
- Options
- Principal Registration
- Registered Options and Security Futures Principal
- Senior Registered Options Principal
- Supervision

Referenced Rules & Notices

- NASD Rule 1022
- NASD Rule 2220
- NASD Rule 2860
- NASD Rule 3010

Background and Discussion

FINRA amended its rules to allow a member firm to integrate the responsibility for supervision and compliance of its public customer options business into its overall supervisory and compliance program. As part of these changes, FINRA eliminated the requirement that a firm must designate a specific officer or general partner to serve as the Senior Registered Options Principal (SROP), and a specific individual (who may also be the SROP) to serve as the Compliance Registered Options Principal (CROP). The amendments provide member firms with the flexibility to allow several individuals to fulfill these supervisory functions, in accordance with the firm's overall supervisory structure. FINRA reminds firms of their obligation to designate appropriately registered principal(s) to supervise their public customer options activities pursuant to NASD Rule 3010(a)(2).²

NASD Rule 1022 (Categories of Principal Registration) has been amended to delete the reference to the SROP and CROP and clarify that if a person is engaged in the supervision of a member firm's options and security futures business, including a person designated pursuant to NASD Rule 3010(a)(2), then such person must be registered as a Registered Options and Security Futures Principal (ROSFP).

FINRA also made a few technical changes to the rules.³ All references to "Registered Options Principal" have been changed to "Registered Options and Security Futures Principal," to reflect the change in title when rules governing security futures were adopted.⁴ FINRA notes that this change to the principal title neither requires currently registered options principals to complete the security futures firm element continuing education requirement, nor does it permit a ROSFP to supervise security futures activities unless he or she has satisfied the firm-element continuing education program.⁵

NASD Rule 2220(b) (Options Communications with the Public) has been amended to delete the reference to the CROP and instead requires that all advertisements, sales literature (except completed worksheets) and educational material issued by a member firm pertaining to options be approved in advance by a ROSFP designated by the member firm's written supervisory procedures.

In addition, NASD Rule 2860 (Options) has been amended in several respects. First, paragraph (b)(16)(E)(iii) was amended to delete the reference to the SROP and CROP and requires that a specific ROSFP(s) be designated to be responsible for approving customer accounts that do not meet the specific criteria and standards for writing uncovered short option transactions and for maintaining written records of the reasons for every account so approved. This change allows members the flexibility to assign this responsibility, which formerly rested solely with the SROP and/or CROP, to a specific ROSFP(s).

Second, the rule change amends paragraph (b)(18) and the treatment of options discretionary accounts. Under the rule change, each firm must designate specific ROSFPs to review discretionary accounts.⁶ In addition, a ROSFP other than the ROSFP who accepted the account must review the acceptance of each discretionary account to determine that the ROSFP accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risks of the strategies or transactions proposed, and must maintain a record of the basis for such determination.

The rule change also eliminates the requirement in paragraph (b)(18) that a ROSFP approve and initial each discretionary options order on the day of entry provided that a firm uses computerized surveillance tools. Discretionary orders for firms using computerized surveillance tools instead may be reviewed in accordance with the member firm's written supervisory procedures. Firms that do not use computerized surveillance tools must continue to approve and initial each discretionary order on the day entered, as is required today.

Paragraph (b)(18) also has been revised to limit the duration of the time and price discretionary authority to the day such authority is granted, absent specific written authorization by the customer to the contrary. These amendments mirror the limitations to discretionary authority provided in NASD Rule 2510(d).

Finally, paragraph (b)(20) has been revised to delete the reference to the SROP and CROP and clarify that each member firm that conducts a public customer options business must ensure that its written supervisory system policies and procedures pursuant to NASD Rules 3010, 3012 and 3013 adequately address the firm's public customer options business. Although the rule change eliminated entirely the positions and titles of the SROP and CROP, a firm is still required pursuant to NASD Rule 3010(a)(2) to designate "an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required," which would include designating one or more ROSFPs to supervise a member firm's public customer options activities.

The amendments become effective on June 23, 2008.

Endnotes

- 1 See Securities Exchange Act Release No. 57775 (May 5, 2008), 73 FR 26453 (May 9, 2008) (Approval Order of SR-FINRA-2007-035).
- 2 NASD Rule 3010(a)(2) requires that member firms designate “an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker/dealer is required.”
- 3 All references to “the Association” have been changed to “NASD” for ease of reference while the rules continue to be part of the legacy NASD rulebook, until such time as the legacy NASD and incorporated NYSE rules are consolidated into the FINRA rulebook when all references to “NASD” will be changed to “FINRA.”
- 4 See Securities Exchange Act Release No. 46663 (October 15, 2002), 67 FR 64944 (October 22, 2002) (Approval Order for File No. SR-NASD-2002-040).
- 5 See *Notice to Members 02-73* (November 2002).
- 6 Previously, the SROP was required to review the acceptance of each discretionary account and the CROP was required to perform frequent supervisory review of such accounts.

ATTACHMENT A

New language is underlined, deletions are in brackets.

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1022. Categories of Principal Registration

(a) through (e) No Change.

(f) Limited Principal – Registered Options and Security Futures

(1) Every member of [the Association]NASD that is engaged in, or that intends to engage in transactions in security futures or [put or call] options with the public shall have at least one Registered Options and Security Futures Principal who shall have satisfied the requirements of this subparagraph. [As to options transactions, each member shall also designate a Senior Registered Options Principal and a Compliance Registered Options Principal in accordance with the provisions of Rule 2860(b)(20) and identify such persons to the Association.] Every person engaged in the supervision of options and security futures sales practices, including a person designated pursuant to Rule 3010(a)(2) [the management of the day-to-day options or security futures activities of a member] shall [also] be registered as a Registered Options and Security Futures Principal.

(2) through (5) No Change.

(g) through (h) No Change.

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2220. Options Communications with the Public

(a) No Change.

(b) Approval by [Compliance]a Registered Options and Security Futures Principal and Recordkeeping

All advertisements, sales literature (except completed worksheets), and educational material issued by a member or member organization pertaining to options shall be approved in advance by [the Compliance Registered Options Principal or designee]a Registered Options and Security Futures Principal designated by the member's written supervisory procedures. Copies thereof, together with the names of the persons who prepared the material, the names of the persons who approved the material and, in the case of sales literature, the source of any recommendations contained therein, shall be

retained by the member or member organization and be kept at an easily accessible place for examination by [the Association]NASD for a period of three years.

(c) through (d) No Change.

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2860. Options

(a) No Change.

(b) Requirements

(1) through (15) No Change.

(16) Opening of Accounts

(A) through (D) No Change.

(E) Uncovered Short Option Contracts

Each member transacting business with the public in writing uncovered short option contracts shall develop, implement and maintain specific written procedures governing the conduct of such business which shall include, at least, the following:

(i) through (ii) No Change.

(iii) Designation of [the Senior Registered Options Principal and/or Compliance Registered Options Principal] a specific Registered Options and Security Futures Principal(s) as [the person] responsible for approving customer accounts that do not meet the specific criteria and standards for writing uncovered short option transactions and for maintaining written records of the reasons for every account so approved;

(iv) through (v) No Change.

(17) No Change.

(18) Discretionary Accounts

(A) Authorization and Approval

(i) No Change.

(ii) [The Senior Registered Options Principal] Each firm shall designate specific Registered Options and Security Futures Principals to review discretionary accounts. A Registered Options and Security Futures Principal other than the Registered Options and Security Futures Principal who accepted the account shall review the acceptance of each discretionary account to determine that the Registered Options and Security Futures Principal accepting the account had a reasonable basis for believing that the customer was able to understand and bear the risk of the strategies or transactions proposed, and shall maintain a record of the basis for such determination. [Each discretionary order shall be approved and initialed on the day entered by the branch office manager or other Registered Options Principal, provided that if the branch office manager is not a Registered Options Principal, such approval shall be confirmed within a reasonable time by a Registered Options Principal. Each] Every discretionary order shall be identified as discretionary on the order at the time of entry. Discretionary accounts shall receive frequent appropriate supervisory review by [the Compliance Registered Options Principal] a Registered Options and Security Futures Principal who is not exercising the discretionary authority. The provisions of this subparagraph (18) shall not apply to 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 specified security shall be executed, except that the authority to exercise time and price discretion will be considered to be in effect only until the end of the business day on which the customer granted such discretion, absent specific, written contrary indication signed and dated by the customer. This limitation shall not apply to time and price discretion exercised in an institutional account, as defined in Rule 3110(c)(4), pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis. Any exercise of time and price discretion must be reflected on the order ticket.

(iii) Any member that does not utilize computerized surveillance tools for the frequent and appropriate review of discretionary activity must establish and implement procedures to require specific Registered Options and Security Futures Principals who have been designated to review discretionary accounts to approve and initial each discretionary order on the day entered.

(B) through (C) No Change.

(19) No Change.

(20) Supervision of Accounts

(A) Duty to Supervise[; Senior Registered Options Principal]

[Every member shall develop and implement a written program providing for the diligent supervision of all of its customer accounts, and all orders in such accounts, to the extent such accounts and orders relate to options contracts, by a general partner (in the case of a partnership) or officer (in the case of a corporation) of the member who is a Registered Options Principal and who has been specifically identified to the Association as the member's Senior Registered Options Principal. A Senior Registered Options Principal, in meeting his responsibilities for supervision of customer accounts and orders, may delegate to qualified employees (including other Registered Options Principals) responsibility and authority for supervision and control of each branch office handling transactions in option contracts, provided that the Senior Registered Options Principal shall have overall authority and responsibility for establishing appropriate procedures of supervision and control over such employees. Every such member shall also develop and implement specific written procedures concerning the manner of supervision of customer accounts maintaining uncovered short option positions and specifically providing for frequent supervisory review of such accounts.]Each member that conducts a public customer options business shall ensure that its written supervisory system policies and procedures pursuant to Rules 3010, 3012, and 3013 adequately address the member's public customer options business.

[(B) Compliance Registered Options Principal]

[Every member shall designate and specifically identify to the Association a Compliance Registered Options Principal (CROP), who may be the Senior Registered Options Principal, who shall have no sales functions and who shall be responsible to review and to propose appropriate action to secure the member's compliance with securities laws and regulations and Association Rules in respect of its options business. The CROP shall regularly furnish reports directly to the Compliance officer (if the CROP is not himself the Compliance officer) and to other senior management of the member. The

requirement that the CROP have no sales functions shall not apply to a member that has received less than \$1,000,000 in gross commissions on options business for either of the preceding two fiscal years or that currently has ten or fewer registered representatives.]

[(C)](B) Branch Offices

No branch office of a member shall transact an options business unless the principal supervisor of such branch office accepting options transactions has been qualified as either a Registered Options and Security Futures Principal or a Limited Principal—General Securities Sales Supervisor; provided that this requirement shall not apply to branch offices in which no more than three registered representatives are located, so long as the options activities of such branch offices are appropriately supervised by either a Registered Options and Security Futures Principal or a Limited Principal—General Securities Sales Supervisor.

[(D)](C) Headquarters Review of Accounts

Each member shall maintain at the principal supervisory office having jurisdiction over the office servicing customer accounts, or have readily accessible and promptly retrievable, information to permit review of each customer's options account on a timely basis to determine:

- (i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved;
- (ii) the size and frequency of options transactions;
- (iii) commission activity in the account;
- (iv) profit or loss in the account;
- (v) undue concentration in any options class or classes, and
- (vi) compliance with the provisions of Regulation T of the Federal Reserve Board.

(21) through (24) No Change.

(c) No Change.

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