SWIMMING NAKED WHEN THE TIDE GOES OUT NAKED/SHORT OPTIONS 2013

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INTRODUCTION

Warren Buffet probably had no idea that his famous quote, "After all, you only find out who is swimming naked when the tide goes out,"[2] would apply so perfectly to "naked" options. Let's analyze what the "Oracle of Omaha" may have been suggesting to Berkshire Hathaway shareholders. There are numerous business ventures and investments that can both survive and even thrive when market conditions are positive or even neutral. That is the easy part of the game. Savvy, successful entrepreneurs and investors are likely to tell you that to be successful long-term, one must fully understand downside risks—and be positioned to manage those risks.

Businesses are constantly impacted by cycles. A business that survives only in times of growth and prosperity but falters or fails during contractionary periods is probably a poorly managed business. Likewise, the securities markets have their own swings; one need only refer to a long-term chart of the S&P 500 to see evidence of recurring "boom and bust" patterns. History has proven there is no individual who is smart enough or lucky enough to guess exactly when the up or down cycles in the U.S. securities markets are going to change. Any investor, money manager or long-term

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2. Buffet, Warren, Chairman of the Berkshire Hathaway Board of Directors, *2001 Annual Letter to Shareholders*, (Feb. 28, 2002), *available at* http://www.berkshirehathaway.com/2001ar/2001 letter.html.

investor would not last long if s/he used investment strategies that worked only in "bull" market expansions, but were severely damaged in "bear" market contractions.

Such is the risk scenario for option writers. Because statistics indicate that only 17% of all options are ever exercised,[3] too many investors interpret this to mean that the buyers of options have most of the risk. But that 17% of the time is where the greatest damage/losses occur.[4] And when that 17% is combined with a significant move in the markets, all the profits gained from being right 83% of the time can be wiped out in an instant, causing the investor to lose more than was invested.

Now add to this dangerous investment philosophy the fact that many brokerage firms encourage investors to participate in these option-writing programs, only to constrain the investor in volatile times by limiting or even canceling the ability to trade out of the dilemma.

"FINANCIAL WEAPONS OF MASS DESTRUCTION"[5] – NAKED OPTIONS

When testifying as an expert witness in an option case, I am often asked to describe the risk of "naked" options trading.[6] When describing such risk,

3. Options Clearing Corporation, OCC, 2006, 17% of all options are exercised, 35% of options expire worthless, 48% of options are bought or sold to close the position. A later study, 2009, suggested only 10% of options are exercised, 30% of options expire worthless, and 60% of options are offered or sold before expiration.

4. There are some particular option strategies, though rare, where a trader might prefer to be exercised.

5. Mr. Buffet coined this phrase in a letter to shareholders, in which he opined, "In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." Buffet, Warren, Chairman of the Berkshire Hathaway Board of Directors, *2002 Annual Letter to Shareholders*, (Feb. 28, 2002), *available at* http://www.berkshirehathaway.com/letters/2002pdf.pdf.

6. *Investopedia* defines a "naked" option trade as follows:

> A trading position where the seller of an option contract does not own any, or enough, of the underlying security to act as protection against adverse price movements. If the price of the underlying security moves against the trader, who does not already own the underlying security, he or she would be required to purchase the shares regardless of how high the price is. The potential for losses, then, can be unlimited, and as a result, brokers typically

it is most effective to do so by comparing one investment vehicle against another. I often compare naked options to commodities because a majority of people assume that commodities are the riskiest of all investments. Having done extensive trading in both naked options and commodities, it is my professional opinion that naked options can often be the riskier. Let me tell you why that is so:

- *How risk is defined or understood.* Whether a naïve investor or a professional, almost 100% of them would admit to believing that commodities are incredibly risky. The opposite is often true for options, in that many investors believe that options are relatively safe and that this includes naked/short options. A misunderstanding of the inherent risks of any investment increases the risk of that investment.
- *Commodities obviously are more complex.* The mere fact that commodities are not regulated by the Securities Exchange Commission ("SEC") or Financial Industry Regulatory Authority ("FINRA") scares off many investors. While stock and index options appear, on the surface, to be correlated to the underlying security, commodities are in an entirely different category. Investors may possess a greater (false) sense of security with options due to their correlation with the underlying security and because they are regulated.
- *Trading commodities is more restricted than trading options*. A broker must receive separate training and a separate license (Series 3) to trade commodities and the brokerage firm must be commodity-licensed. For commodities trading, the investor is required to maintain a totally separate account. The opposite is true for options. Any Series 7 registered representative and registered brokerage firm can trade options alongside stocks, bonds and other traditional investment products. The investor is required only to sign an options trading customer agreement, inculcating them with a false sense of security about the perceived safety of options trading.
- *Options are a "wasting" asset.*[7] Yes, commodity futures contracts do expire on dates certain. However, one should not lose sight of the fact

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> have specific rules regarding naked trading. Inexperienced traders, for example, would not be allowed to place this type of order.

Available at http://www.investopedia.com/terms/n/nakedoption.asp#ixzz2JCutREk6.

7. Option contracts are considered "wasting" assets because all options expire after a finite time period. The expiration month is specified for each option contract. The specific date on which expiration occurs depends on the type of option. For instance, stock options on the CBOE expire on the Saturday immediately following the third

that there can be cost in renewing or "rolling over" a commodity futures contract, a cost that is incomparable with the total loss of the options price/premium at its expiration date.[8]

- *The misperception that commodities pose greater risk because of the leverage and volatility of commodities contracts.* Commodities have limits on the amount they can move in any given trading day. Stock can have a massive percentage move within a given day and stock options can experience even greater price movements and volatility. When it comes to leverage, both stock and index options allow investors to control millions of dollars of underlying securities and indices, with investments of only thousands of dollars. The common misunderstanding of volatility and leverage can result in significant losses for both long and short option investors.
- *The misunderstood price and premium of options*. The price of corn is the price of corn and a futures contract on corn is generally synonymous with that underlying commodity.[9] Not so for options. The price/premium of an option has numerous, complicated nuances understood by only a small percentage of investors.

Regarding the general risk of naked options trading, consider this quiz:

Q: *Who loses money in a "bull" market?*

A: Few investors because most use "long" investment strategies.

Q: *Who loses money in a neutral or sideways market?*

A: Few investors because the only real losses might be opportunity cost compared to out-of-pocket cost. Stocks that pay dividends can create positive results even during a "flat" market.

Q: *Who loses money in a "bear" market?*

A: For a long-term stock investor, historical market statistics show that as long as an investor can stay invested, bear markets are generally short-term interruptions to long term,

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Friday of the expiration month. Once a stock option expires, the contractual right to exercise no longer exists and the security becomes worthless. *See* http://www.cboe.com/LearnCenter/Concepts/Beyond/expiration. aspx.

8. Option contracts to purchase (or sell) commodity futures contracts exist, but exceed the scope of this article.

9. Commodity futures contracts prices sometimes disconnect from the underlying commodity, an occurrence commonly known as "divergence."

positive returns.[10] Aggressive stock investors utilizing margin, on the other hand, can sustain significant losses. Because of leverage, naked option writers can be totally wiped out and even lose more than their original investment.

OPTION COMMISSIONS AND INHERENT CONFLICTS OF INTEREST

When investing in any security, one must first determine what conflicts of interest exist.[11] When dealing with a brokerage firm, the natural built-in conflicts of interest include the commissions and fees paid by a customer. Brokerage firms take none of the risk,; they receive commissions and fees regardless of whether the client loses money or not.[12] It is often the most illiquid and highest risk investments that provide the highest commissions and fees. This is especially true when it comes to options. With the advent in 1975 of un-fixing brokerage commissions and with the explosive growth in online discount trading firms in the late '90s, brokerage firms saw their basic stock and bond commission rates shrink. Option trading represents a lucrative commission stream for the brokerage industry, and, with it, a substantial conflict of interest in the form of a financial incentive to sell option contracts to customers.

While, brokerage firms do not charge for options that expire worthless, only 30% to 35% of option contracts expire worthless.[13] When an option

10. The last 12 years have seen both more frequent and longer bear market cycles in stocks in the U.S. markets. Additionally, many investors do not have the luxury of waiting out bear markets.

11. DOUGLAS J. SCHULZ & TRACY PRIDE STONEMAN, BROKERAGE FRAUD-WHAT WALL STREET DOESN'T WANT YOU TO KNOW, (Dearborn Publishing, 2002).

12. Brokerage firms' business platforms are designed so that all the various risks taken by their clients are borne by the client and not the firm. One of the main reasons for the margin requirements is to protect the brokerage firms' capital. Technically, the firm does have risk exposure when the trading in an account creates a debit. Yet, the brokerage firm can always sue the client for any deficiencies created based on the terms and conditions of the typical customer margin agreement.

13. According to Options Clearing Corporation (OCC) data, 2006, 17% of options are exercised, 35% of options expire worthless, 48% of options are bought or sold to close the position. A similar 2009 study suggested only 10% of options are exercised, 30% of options expire worthless, and 60% of options are offered or sold before expiration.

contract is exercised, the customer is charged commissions for having the underlying stock either "put" to or "called away."[14] When one considers that most options traded are only a few months in duration, and that between 45% and 60% of the time the customer trades out of options held, substantial trading activity and commissions are the result.

UBS COMMISSION SCHEDULE[15] - PROVING THE POINT

If a UBS customer buys 500 shares of a $20 stock, which equates to an investment of $10,000, a commission of $248.75 plus a $5.25 processing fee, or a total cost of $254, is incurred. The customer pays an effective 2.54% commission. Alternatively, if this same UBS customer invests $10,000 to purchase (or sell) 20 option contracts, the cost will be: 1.4492% of the principal; a fee of $35.69; $9.355 per each of the first ten contracts; and, $5.84 for every contract after the first ten. This results in a total transaction cost of $332.56. Thus, the transaction cost for the options is 30% *greater* than an investment of the same amount of money used to purchase stocks.

FIDELITY COMMISSION SCHEDULE – ANOTHER EXAMPLE

If a Fidelity customer buys 500 shares of a $20 stock, a $7.95 commission is charged. If the customer were to invest $10,000 in 20 option contracts, a $7.95 commission and $.75 per contract is charged, for a total transaction cost of $22.95, an almost 90% higher cost to purchase options contracts versus shares of stock.

Nevertheless, options are time sensitive, which means that when they expire, an investor is forced to either close out the open options position or "roll out." [16] When one considers that the average price of a stock listed on

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14. American versus European options: American-style options can be exercised any time before the expiration date. European options, on the other hand, may be exercised only on the expiration date. Currently, all of the stock options traded domestically are of the American variety.

15. UBS Commission Schedule, *available at* http://www.ubs.com/content/dam/static/wmamericas/commission_schedules.pdf.

16. A "roll" is a follow-up transaction in which the investor closes options currently in the position and opens other options with different terms, on the same underlying stock/index. This assumes the investor wants to maintain his position/strategy.

the New York Stock Exchange ("NYSE") is a multiple of the average price of an option traded on the Chicago Board Options Exchange ("CBOE"), one quickly realizes that you can get more "bang for your buck" (leverage) with options. Active options traders generate substantially more commission dollars for brokerage firms when compared to stock or bond traders using the same dollar amount of capital to invest. Where there are huge commissions and profits to be made, there is by nature a built-in conflict of interest. It has been my experience that the trading, compliance and supervisory departments of brokerage firms often become "see no evil, hear no evil, speak no evil" with regard to such customer accounts.

ONLINE OPTION TRADING – "COME ENTER MY WEB" SAID THE SPIDER

Perhaps within the next decade, online gambling will be legalized across this country. But Americans need not wait; they can gamble to their hearts' content (and to their financial detriment) by trading options at any online trading firm. For decades, the self-regulatory organizations required licensed broker-dealers to ensure that all solicited trades were suitable for their customers. With the technology and telecommunications boom of the late '90s and the advent of online trading, the securities industry pressured regulators to relax suitability requirements. Regulators reversed their earlier regulations and requirements in Notice to Members (NTM) 01-23, which was indeed a sad day for investors.[17] As of 2001, if the brokerage firm – be it a typical brick and mortar firm such as Merrill Lynch, Morgan Stanley and UBS or an online firm such as TD Waterhouse, Charles Schwab and Ameritrade – could establish that the disputed trades were unsolicited,[18] the

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LAWRENCE G MCMILLAN, OPTIONS AS A STRATEGIC INVESTMENT, NEW YORK INST. OF FINANCE, Penguin Putnam – Prentice Hall (4th Ed. 2002).

17. *See* NASD Notice to Members 01-23 (April 2001), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003887.pdf.

18. For the definition of and discussion regarding securities regulations related to the term "unsolicited," see two of my earlier articles: *Unauthorized Trading, Time and Price Discretion & The Mismarking Of Order Tickets*, Securities Arbitration 2001, Practicing Law Institute (PLI), New York City (Aug. 15, 2001), and *When Is An Order An Order? Unauthorized Trading By Securities Brokers*, Securities Arbitration, PLI (1994).

firms could allow an investor to totally blow himself up regardless of how unsuitable the activity might be. Now even a "little old lady in tennis shoes" can wipe out her life savings, while her brokerage firm sits idly by.

Let's fast-forward to the last few years. Online brokerage firms realized that incredible revenues/commissions could be generated by offering investors somewhat sophisticated option trading platforms. As a result of the opportunity to generate substantial revenues, online brokerage firms specializing in such trading were created. For example, the firm Interactive Brokers states the following:

We offer multiple trading platforms that provide the ideal environment for all types of traders:

- *Traders who prefer a clean and simple interface can use our HTML-based WebTrader, which makes it easy to view market data, submit orders, and monitor your account and executions.*
- *Traders who require more sophisticated trading tools can use our market maker-designed Trader Workstation (TWS), which optimizes your trading speed and efficiency with an easy-to-use spreadsheet interface, support for more than 50 order types, task-specific trading tools for all trading styles, and real-time account balance and activity monitoring.*
- *Traders on-the-go can use one of our mobile solutions, including mobileTWS for iPhone™, TWS for Blackberry® and MobileTrader.*[19]

OptionsXpress, a division of Charles Schwab, states:

> ***Experience Powerful, Easy-to-Use Tools***
> *Find ideas and place your trades with intuitive, easy-to-use trading tools including:*
> ***All-In-One Trade Ticket***
> *Called by Barron's a "model for the industry"*[20] *our All-In-One Trade Ticket lets you easily build strategies and place all your trades from a single screen.*
> ***Strategy Scan***
> *Identify options strategies based on your personal risk tolerance and sentiment of the underlying symbol.*
> ***Trade & Probability Calculator***
> *Quickly identify the opportunity and risk of an options trade with the Trade & Probability Calculator.*
> ***Virtual Trade***

19. *See* http://www.interactivebrokers.com.

20. http://www.optionsxpress.com/security_risks/disclosures.aspx#awards.

> *Test your strategies and ideas risk-free with $25,000 in a Virtual Trade account.*[21]

TD Ameritrade's Web site - the "Sink or Swim" option trading platform/program - states:

> *Finally, a trading platform that lives up to its traders.*
> *Take your game to the next level with thinkorswim*
> *Get elite-level trading tools and analytics with thinkorswim. Trade equities, options, futures, and Forex in your own personal trading HQ powered by insights, education, and tools to help you nail even complex strategies and techniques. Plus, if you are leveraging portfolio margin to diversify, hedge risk, and potentially lower margin requirements in your qualified account, only the thinkorswim platform displays Portfolio Margin* requirements using a theoretical pricing model.*[22]

TDAmeritrade's CEO, Fred Tomczyk, wrote to customers during the market turmoil of 2009:: *"Our robust technology and tools allowed our clients to navigate these difficult market conditions."*[23]

Come on in, said the spider to the fly.

THE HOTEL CALIFORNIA ACCOUNT RELATIONSHIP

The Eagles sung it best in their hit song, *Hotel California*, "You can check out any time you like, but you can never leave."[24] Online trading firms far too often implement a "Hotel California" business model Large active option trading accounts are lucrative for online brokerage firms. The firms market and advertise their option trading platforms as being "state-of-the-art" tools. They entice customers into active option trading activity by promising special and sophisticated services.

Sometimes customers are offered special margin interest rates and other privileges. Additionally, under the new FINRA "Portfolio Margin" guidelines, investors are allowed, if they meet certain requirements and minimum equity balances, to increase the size of their leverage/margin positions in ways that would otherwise not be permitted.

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21. http://www.optionsxpress.com.

22. http://www.tdameritrade.com.

23. https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA6312.pdf.

24. Don Felder, Glenn Frey, Don Henley, on *Hotel California* (Asylum 1977).

But when markets become volatile, many of those firms get nervous and take action that is adverse to their customers' best interests. It is not only the broker-dealers, but also the regulators, who go to great lengths to ensure firms do not risk their capital, but instead that all the risk is squarely on the customers' shoulders (at least as it relates to margin).

Brokerage firm policies and customer agreements are typically one-sided contracts of adhesion and when customers sign the firms' "customer agreements," they acquiesce to this one-sided contract. This is especially true when it comes to the margin agreement, which is required when a customer seeks to trade naked/short options. All naked/short option contract transactions are by definition margined trades.[25] The terms and conditions of these agreements essentially state that the brokerage firm can do whatever it wants and whenever it wants with respect to margin accounts. One might wonder why *any* customer would ever sign such a one-sided contract of adhesion. The likely answer is that every brokerage firm has these provisions in their contracts and retail customers possess no bargaining power to take their business to a broker-dealer that does not require these conditions.

Too often brokerage firms abuse their one-sided contracts. There are many ways in which they do this, but here I am referring to the "Hotel California" maneuver, where the brokerage firms allow clients to put on thousands of contracts worth millions of dollars, but when volatility escalates, and the firms gets nervous, they just "pull the rug out from under" their customers.

Many investors begin option trading aware of the volatility and risk. Many sophisticated option traders thrive on volatility, because it swells option prices/premiums (increase in value) and opportunities to capture profits. There is even an accepted measure of this volatility known as the "VIX," the CBOE implied volatility index of S&P 500 index options, which expresses expected market volatility over a 30-day period.

Investors should only conduct their brokerage business with reputable, large brokerage firms that have been in business for decades. You want to make sure your brokerage firm is there when you need it. Volatile times and bear markets come and go: what an investor and especially an active, large trader wants and needs is a firm that can handle his business in all kinds of markets. Why would anyone open an account with a brokerage firm that panics during volatile or bear markets?

25. This does not mean there is margin interest being charged, but only that there is a margin requirement.

The sad reality is that these brokerage firms are more than willing to sit by and allow customers, especially active large investors who are generating millions of dollars in commissions and fees for the firms, to build up massive large option positions, including naked options positions. Months and years can go by with thousands of trades taking place on an annual basis and the brokerage firm collects millions in commissions. Eventually there is a major move in the market. Many sophisticated, experienced option traders are not surprised by these trends or increases in volatility. But broker-dealers are staffed with young, inexperienced individuals who tend to panic when markets are volatile. The first steps these firms take when they become nervous is to start limiting and restricting the trading in their customers' accounts, especially those with large, naked options positions. The firms immediately hold up their one-sided customer contracts and point to the language that says they can do what they want when they want.

Every state's law recognizes that in every contract or agreement there is an implied promise of good faith and fair dealing. This means that each party will not do anything to unfairly interfere with the right of any other party to receive the benefits of the contract. Securities regulators have for decades had a similar rule that states, "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[26] These are powerful provisions to help ensure that brokerage firms treat their customers and their customers' accounts fairly and professionally.

THE BLIND LEADING THE BLIND

Some option trading can be relatively simple. With just a little work, most people can quickly figure out what it means to buy an option. Even then, it is a lot more complicated than just buying a stock. When buying an option contract, customers need to know the answers to these basic questions:

- How many shares of the underlying stock does one option contract control?
- What are the various cycles (time periods/expiration dates) available for each option?
- What is the exact number of days until expiration?

26. FINRA Rule 2010

- What is the mathematical equation to determine the cost and fees of purchasing one contract?
- What is the difference between a "put" and "call" option contract?

It is essential to understand additional nuances, such as: what makes up the value/premium of an option contract, which includes such things as time value and intrinsic value. And this is the simple part of trading options.

What if an investor wants to trade options by shorting them, often referred to as selling naked options? It is somewhat similar to selling a stock short, but with more variances and complications. One of the complications attendant to "option writing" (i.e., selling options short/naked) is understanding obligations that are incurred by being short an option contract. The person who purchases options has no such obligations as the owner of the option contract.

The opposite is true for shorting options. Because the customer sold something s/he did not own, the seller of short options has obligations that must be observed, such as the fact that an investor who has sold options short has given the counterparty (who took the other side of the contract, who purchased the contract the customer sold)– the right to demand certain actions.[27] On a short put contract, the short seller can be forced to buy 100 shares/units times the number of contracts sold short or to deliver 100 shares/units times the number of call contracts sold short. And if this short seller does not have those shares/units to deliver, s/he must go out into the open market and buy them in order to deliver them.

Problems occur for large, active naked option traders in the area of margin. Determining exactly how margin (both initial and maintenance margin) is calculated, much less trying to do the actual margin calculations, is something that few people comprehend. It is very dangerous when investors enter into the arena of large-scale selling of naked options, especially when they do not fully comprehend margin requirements. What is worse is when the brokerage firms that advertise sophisticated option platforms with the ability and staff to calculate margin requirements fail to do so. That is a recipe for disaster – for the customer.

With regard to options trading, brokerage firms are often staffed by people ill-equipped for their positions. I have participated in a number of option trading cases in which the testimony of brokerage firm employees responsible for option trading and margin calculation, reveals that either

27. In actuality, though there is a person on the other side of every option contract, the OCC matches all trades, and an investor is not technically dealing directly with the person who purchased his naked contract.

they: 1) have never traded options; 2) have worked in the brokerage industry for only a few years; 3) are new to the options departments; and 4) are unfamiliar with the option strategy being utilized by the claimant-investor. Internal e-mails and voice recordings between employees of these brokerage firms is like listening to an Abbott and Costello skit. No one can figure out the risk parameters or current margin requirements on client positions. Since most investors are not capable of fully understanding or calculating margin requirements, they must rely on the brokerage firm's margin departments. Particularly in volatile markets, "the blind are leading the blind" into calamities.

PROFESSIONALISM, ADEQUACY & ABILITY

Though brokerage firms would like customers to believe all the obligations and duties that flow from the "customer agreement" and "margin agreement" are borne by the client, that is not the case. Customers are not regulated; brokerage firms are. Though the firms advertise their expertise, sophisticated trading platforms and the ability to fully manage an option traders' every need, firms also agree to know, implement and follow securities regulations.[28] When firms fail to fulfill their obligations, they can be held liable for negligence and be responsible for client losses.

The technology boom caused online trading to skyrocket. E*TRADE, TD Waterhouse, Ameritrade, Brown and Company, DLJ, Fidelity and Charles Schwab are just a few of the firms for whom business exploded. However, their marketing departments were not talking to their trading departments, or if they were talking, one of them was not listening. If they had been communicating, they would have known they were opening customer accounts so quickly that the trading departments could not keep up with the order volume. Investors were soon learning that their trades were not filled properly.[29]

When regulators became aware of trading problems at online firms, they released a series of regulatory interpretations, including:

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28. The source of this obligation is through the firm's licensing with FINRA, though often the obligation to adhere to the securities rules is also found in "customer agreement."

29. I was inundated with phone calls at the time, because I was writing a series of articles on the risk of Internet/online trading and personally had six different online trading accounts.

1. *NASD Notice to Members 99-11*[30] - *Guidance Regarding Stock Volatility*

- Member firms must have adequate systems capacity to handle high volume or high volatility trading days. Firms should provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner.
- Firms' procedures for handling customer orders must be fair, consistent and reasonable during volatile market conditions and otherwise.
- Firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services. These communications must not exaggerate the members' capabilities or omit material information about the risks of trading and the possibilities of delayed executions. Members should have the system capacity to support any claims they make about their trading services.
- Misrepresentations or omissions of material facts in public communications violate NASD Rule 2210 as well as Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade.

2. *NASD Notice to Members 99-12*[31] - *Guidance Concerning The Operation Of Automated Order Execution Systems During Turbulent Market Conditions*

- NASD Regulation believes that members' best execution obligations require that such algorithms and procedures treat customer orders in a fair, consistent, and reasonable manner.
- As a general matter, these systems[32] should be designed to process and execute orders during non-turbulent market conditions in a fair, consistent, and reasonable manner and have a capacity that is

30. http://www.finra.org/Industry/Regulation/Notices/1999/p004563, February 1999.

31. http://www.finra.org/Industry/Regulation/Notices/1999/P004554.

32. These "systems" are automated order execution systems for smaller customer orders, generally 3,000 shares or less.

adequate to handle reasonably anticipated trading volume in an efficient manner.

The SEC had issued the following legal bulletin which resulted from the volatile markets on October 27 and 28, 1997 when "circuit breakers" were instituted during the trading day.[33]

3. *SEC Staff Legal Bulletin No. 8 (MR) - Division of Market Regulation - September 9, 1998*

- Broker-Dealers Need to Have Enough Systems Capacity to Ensure a High Degree of Operational Capability Access Problems Faced by Customers of Online Broker-Dealers - The Division seeks to emphasize to broker-dealers the importance of having adequate capacity to handle high volume or high volatility trading days, and conducting capacity planning on a regular basis.
- Outsourcing Does Not Excuse Broker-Dealers from Focusing on Capacity Issues.

DAYDREAM TRADING EXAMPLE

Allow me to give you a specific example on brokerage firms "pulling the rug out from under" their clients when they get nervous in volatile markets. In FINRA arbitration Case No. 09-02054: *Daydream Trading, LLC, et al. v. TD Ameritrade, Inc*,[34] my client ran Daydream Trading, a sophisticated option trading program firm that specialized in trading "Iron Condor's," an advanced option strategies using spreads.[35] It opened an Ameritrade option trading account because of its claimed ability to deal with sophisticated trading demands. For years, the client traded through an Ameritrade account,

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33. Circuit Breakers (Trading Curbs) are market regulation mechanisms put in place by the regulators to halt trading when certain market movement criteria are triggered. The goal is to allow the markets to regroup and cool down during volatile market conditions.

34. This case was referred to in an earlier PIABA BAR JOURNAL Vol. 17 No 3, as one of the more significant awards.

35. The "Iron Condor" is an advanced option trading strategy utilizing two vertical spreads – a Bull Put Spread and a Bear Call Spread, each with the same expiration and an equal number of call spreads as put spreads.

which was profitable for him and very profitable for Ameritrade. As the market volatility escalated in 2008, Ameritrade panicked and abruptly halted all trading in the client's account except for closing transactions. Because of the nature of the type of option spreads that the client held and the timing of Ameritrade's trading restrictions, the client's account was nearly wiped out.

The defense by Ameritrade was that the "customer agreement" gave Ameritrade the right to halt or limit my client's trading at any time, hence the "pulling the rug out from under" the client. As the expert witness, I testified that regardless of what the customer agreement stated, the norms and standards of the securities regulations require licensed broker-dealers to deal in good faith and fairly with their clients. I cited what is now FINRA Rule 2010, entitled *Standards of Commercial Honor and Principles of Trade*. The arbitrators rejected Ameritrade's "contract" defense and awarded the claimant $6,924,538, assessing all of arbitration costs against the firm.

In the Daydream case, Ameritrade would not let the claimant roll his positions or make new positions to try to adjust his account to the fast volatile market. This is basically a death sentence for an option trader, especially one who uses spreads, straddles, strangles and naked options. In that case, the claimant-customer also had been trading extensively with the brokerage firm without incident. He held numerous short option positions as part of various options strategies, but generally he tended to be short both puts and calls on a particular stock index. When market volatility escalated and the claimant's margin buying power was eliminated, his account was subject to a margin call. Just as in the Daydream case, the brokerage firm restricted the trading activity, allowing only "closing orders."

In another naked option case in which I participated, employees at an online brokerage firm refused to allow the claimant-customer to enter closing transactions, even when he explained that the trades were closing transactions and that he was not establishing a new position. The brokerage firm allowed the claimant to establish thousands of contracts, risking millions of dollars (checking into the Hotel California). But when the claimant tried to enter closing transactions (checking out of the hotel), the firm refused to effect the closing orders. When a brokerage firm confuses the customer's closing orders for open positions, the negligence is somewhere beyond comprehension, not to mention a serious violation of the norms, standards and regulations of the securities industry.

KNOWINGLY UNDERSTATING NAKED OPTIONS RISKS

Some brokerage firms knowingly understate the risk and exposure to a client in naked option contracts. When I conferred with other margin option experts in preparation for my expert testimony in a naked option arbitration, I was told that naked option margin requirements are never adequate when you have a stock that is dropping fast. Naked option exposure is the number and contracts and ultimately the number of dollars that a customer's account can be committed to buy (or sell) if the naked options are exercised against the customer. In one case in which I was the customer's expert, it was $85 million. Simple arithmetic explains how this account, with only $17 million in equity, cannot buy $85 million worth of stock. Even on margin, a $17 million equity account can only buy $34 million worth of stock, and that assumes the $17 million was all in cash and not invested in other securities.

When reviewing page after page of the broker dealer's internal reports on the accounts' "Naked Option Exposure," I learned the firm had calculated the naked option exposure by taking the "in the money"[36] option contracts and subtracting the difference between the strike price and the current price of the underlying stock. The firm's naked option exposure calculations ignored the naked options that were not in the money. This partially explained the broker-dealer's understatement of risk and exposure on these naked option contracts. The second fallacy in the firm's naked option exposure reports was its calculation of the exposure of those options that were in fact in the money.

PORTFOLIO MARGIN – ADDING FUEL TO THE FIRE

In 2008, FINRA announced the permanence of a portfolio margin pilot program that which contains a new margin calculation system for certain types of accounts. The FINRA Notice to Members is NTM 08-41 - FINRA Announces Amendments to Make Permanent the Portfolio Margin Pilot Program

- Portfolio margin is a methodology that computes margin requirements for an account based on the greatest projected net loss of all positions in a product class or group, and uses computer

36. If the underlying stock is trading at $50 per share, a put contract with a strike price of $50 is considered to be "at the money." A put contract with a strike price of $55 is considered to be "in the money." A put contract with a strike price of $45 is considered to be "out of the money."

modeling to perform risk analysis using multiple pricing scenarios. The pricing scenarios are designed to measure the theoretical loss of the positions, given changes in the underlying price and implied volatility inputs to the model.

- Accordingly, the margin required is based on the greatest loss that would be incurred in a portfolio if the value of its components move up or down by a predetermined amount.

The following is excerpted from TD Ameritrade's Web site, at a page titled "Portfolio Margin Risk-Disclosure Statement." It minimally describes this new Margin Portfolio policy.

OVERVIEW OF PORTFOLIO MARGIN

1. Portfolio margin is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a "security class" or "product group" as determined by an options theoretical pricing model using multiple pricing scenarios. These pricing scenarios are designed to measure the theoretical loss of the positions given changes in both the underlying price and implied volatility inputs to the model.
2. The goal of portfolio margin is to set levels of margin that more precisely reflect actual net risk. Lower margin requirements allow the client more leverage in an account.

CLIENTS ELIGIBLE FOR PORTFOLIO MARGIN

3. To be eligible for portfolio margin, clients (other than broker/dealers or members of a national futures exchange) must be approved for writing uncovered options.

There are problems/issues with the relatively new portfolio margin policy. Compliance with it policy is even more complicated than it was under the previous policy, particularly when calculating an account's margin requirements. Secondly, because portfolio margin has a minimum account equity, if an account drops below that minimum, just that alone can trigger new additional margin requirements and possible margin calls. Thirdly, it allows investors to increase their leverage, which by definition expands their risk exposure.

MARGIN CALL LIQUDATION – A NOT SO ONE-SIDED EVENT

If a customer's account is highly leveraged either through margined purchases or short sales, there is only one thing more dreaded than a margin call, and that is a forced liquidation. If you are managing and trading your account aggressively, having your investments sold out due to margin call liquidations is going to do permanent damage to your portfolio.

Embedded in most margin agreements is language that gives the brokerage firm the power to liquidate margined positions under special circumstances. But to repeat, brokerage firms must be fair in dealing with clients' accounts even when they have signed margin account agreements. And as you might imagine, experts and lawyers battle at arbitration hearings over the meaning of "fair." What is fair becomes more complicated in an option trading account where the client's positions consist of spreads, straddles, strangles and other complicated options trading strategies. A brief description of option strategies is necessary so the reader can understand the complexities of margin liquidation.[37]

- *Spread Strategy* – Options strategy in which both long and short options of the same type on the same underlying security are acquired at or about the same moment and are held in tandem.
- *Straddle* – The purchase or sale of an equal number of puts and calls having the same terms.
- *Strangle* – A combination involving a put and a call at different strikes with the same expiration date.

These terms are among the simplest and only begin to describe the most basic of strategies. The key point to understand here is that in each options strategy, there are two sides to each of them, that is, the option trader establishes two positions (two different option contracts) for each spread/combination. As the underlying security/index moves or as time elapses, the relationship between each of these contracts adjusts and most often adjusts differently, hence, the reason for putting on a spread, straddle or strangle.

When there is a margin call and the brokerage firm is going to make forced margin call liquidations in an account that has various options spread contracts, how does the brokerage firm decide just what to liquidate? This is not as complex in a brokerage account that is holding stocks and bonds or in an account that is long options, or even in an account that has simple short options, versus an account with spreads. This is because in those accounts,

37. McMillan, *supra* note 16.

there is no spreading or other option strategies, which are essentially combinations (i.e., where each option contract is linked to another option contract).

I have been participated in a great number of option liquidation cases, dating back to the 1987 stock market crash. The reoccurring issues typically involve questions pertaining to fairness, arbitrariness or just plain unprofessionalism in the context of a respondent brokerage firm that did margin call liquidations. Over the decades, I have observed that all too often little to no thought went into liquidation decisions, such as exactly which positions a brokerage firm will or will not liquidate. In a simple stock or bond account the question of what to liquidate is generally not overly complex or material, but when a firm intends to liquidate options spread positions, the matter gets very sticky.

If a brokerage firm lifts[38] one side of a spread, it may increase the risk and the potential losses to the account by leaving only the other side of the spread in place, effectively creating a naked position. This is not in the customer's best interests, yet I have seen this practice on a fairly regular basis. Even with the powerful margin agreement in hand, brokerage firms must act fairly, prudently and professionally, especially when conducting margin call liquidations in an account with linked option trades.

BROKERAGE FIRMS CAN'T PICK AND CHOOSE WHICH RULES TO FOLLOW

As an expert witness, my job is to advise and testify regarding pertinent rules, regulations, norms and standards of the securities industry. I concur with roughly 99% of the regulations. But as an expert and Certified Regulatory Compliance Professional,[39] I do not have the luxury of disagreeing with the regulations any more than brokerage industry members. Securities regulators require broker-dealers to be licensed and their licensed

38. "Lift" is an option trading term for closing out one side of the spread also known as "legging."

39. The Certified Regulatory Compliance Professional ("CRCP") professional certification is offered by the Wharton School of Business in conjunction with FINRA at the Wharton School of Business at the University of Pennsylvania, Philadelphia. CRCP was an extensive course covering such topics as the history of securities regulations, the securities regulations, and supervision and compliance of registered broker-dealers. The author was among the first graduates of this program in 2001.

registered representatives to follow and abide by *all* the relevant regulations. At hearings, brokerage firms often wave around the client's signed customer account agreement.

But the brokerage firms - especially when dealing with option margin cases - often try to convince arbitrators that they need not look beyond the customer agreement, which gives the brokerage firms almost absolute power to close out or restrict a customer's trading activities, regardless of the consequences to the customer's account and his or her portfolio. My testimony on these issues generally goes along the following lines in response to such a hard line contract defense:

> It would serve no purpose, as a securities regulatory expert, to argue against the contractual rights of the brokerage firm under their customer agreement. But the mere fact that the brokerage firm in this case has certain rights under their agreement does not by any means give the firm the right to breach its other regulatory requirements.
>
> The securities regulations do not allow brokerage firms to cherry pick which regulations and policies they choose to follow and which they choose to ignore. The mere fact that the firm was within its rights with regards to certain margin liquidation policies, the licensed broker dealer *still* must follow and adhere to *all* the regulations, at *all* times.

It is at this point in the case I often refer the triers-of-fact to the following securities regulations and interpretations, in addition to regulatory notices listed earlier in this article.

FINRA 2220(d) Options Communications - Standards Applicable to Communications

(2) General Standards

(A) No member or associated person of the member shall use any options communications which:

(i) contains any untrue statement or omission of a material fact or is otherwise false or misleading;

(ii) contains promises of specific results, exaggerated or unwarranted claims, opinions for which there is no reasonable basis or forecasts of future events which are unwarranted or which are not clearly labeled as forecasts;

(iii) contains cautionary statements or caveats that are not legible, are misleading, or are inconsistent with the content of the material;

(iv) would constitute a prospectus as that term is defined in the Securities Act, unless it meets the requirements of Section 10 of the Securities Act;

(v) contains statements suggesting the certain availability of a secondary market for options;

(vi) fails to reflect the risks attendant to options transactions and the complexities of certain options investment strategies;

(vii) fails to include a warning to the effect that options are not suitable for all investors or contains suggestions to the contrary; or

(viii) fails to include a statement that supporting documentation for any claims (including any claims made on behalf of options programs or the options expertise of sales persons), comparison, recommendations, statistics, or other technical data, will be supplied upon request.

(C) Any statement in any options communications referring to the potential opportunities or advantages presented by options shall be balanced by a statement of the corresponding risks. The risk statement shall reflect the same degree of specificity as the statement of opportunities, and broad generalities must be avoided.

Because of the high risks involved in options trading, regulators tend to be stricter regarding communications between brokerage firms and customers. FINRA Rule 2220 does not allow member firms or Associated Persons to make "exaggerated or unwarranted claims," and this would necessarily apply to their abilities to handle the client's sophisticated option trading strategies.

FINRA 2010. Standards of Commercial Honor and Principles of Trade

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

IM-2310-2. Fair Dealing with Customers

(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public.

(2) This does not mean that legitimate sales efforts in the securities business are to be discouraged by requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship. It does mean, however, that sales efforts must be

> *judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.*

CONCLUSION

It is my expert opinion that it is not fair, proper business conduct - let alone consistent with high standards of just and equitable business practices - for a FINRA member firm to allow a customer to build large, complex option positions, while being paid substantial commissions and then limiting or restricting the client's trading activity, because the firm got "nervous" or was no longer "comfortable" with the trading strategies.

Further, it is the brokerage firm that is responsible for losses when its option trading platforms and option margin computers or clerks fail or malfunction. It has been my experience that most judges, juries and arbitrators who hear these cases side with FINRA Rule 2010 and with its underlying principle of fairness.