(Investment Advisers Act Release No. 228)

ADMINISTRATIVE PROCEEDING
FILE NO. 3-640

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.
August 30, 1968

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| In the Matters of<br><br>STANFORD INVESTMENT MANAGEMENT, INC.<br>Los Altos, California<br><br>(801-2854)<br><br>LAWRENCE RONALD ROSS<br>Sunnyvale, California<br><br>(801-3404)<br><br>Investment Advisers Act of 1940 -<br>Section 203(d) | FINDINGS<br>AND<br>OPINION<br>OF THE<br>COMMISSION |

INVESTMENT ADVISER PROCEEDINGS

Misleading Advertising

Where investment adviser, whose business included managing accounts in which clients wrote put and call options, published and circulated advertising brochure soliciting persons to use its management service which gave misleading impression of probability of gains to be achieved in sale of puts and calls under its guidance and unlikelihood of losses, *held*, conduct contrary to required standards under Investment Advisers Act of 1940 and Rules thereunder.

Public Interest

Where investment advisers' advertisement respecting investments in put and call options failed to meet standards of Investment Advisers Act, *held*, under all circumstances, including fact that advertisement followed general pattern of other publications relating to put and call options and was discontinued prior to proceedings, in public interest to censure respondents.

APPEARANCES:

William H. Joseph and W. Stevens Tucker, of the San Francisco Regional Office of the Commission, for the Division of Trading and Markets.

Dorothy von Beroldingen, for Stanford Investment Management, Inc. and Lawrence Ronald Ross.

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Following hearings in private consolidated proceedings pursuant to Section 203(d) of the Investment Advisers Act of 1940 ("Act"), the hearing examiner filed an initial decision in which he found that Stanford Investment Management, Inc. ("Stanford") and Lawrence Ronald Ross willfully violated the Act in various respects and that their registrations as registered investment advisers should be revoked. We granted a petition for review filed by registrants, and they and our Division o Trading and Markets ("Division") filed briefs. Our findings are based upon an independent review of the record.

Since May 1962, Ross has been the president, a director, and the controlling stockholder of Stanford, which became registered as an investment adviser under a prior name in March 1962. In addition, Ross himself as a sole proprietor has been registered as an investment advis since March 1964.

Distribution of Misleading Advertisements

The hearing examiner found that Stanford, aided and abetted by Ross, willfully violated Sections 206(2) and (4) of the Act and Rule 17 CFR 275.206(4)-1(a)(5) thereunder, 1/ in that they published and circulated a brochure entitled "A New Approach to Stock Market Profits" ("Ne Approach") which advertised Stanford's advisory services in a manner calculated to arouse hopes of quick and substantial profits to subscrib ers to such services. 2/

Part of Stanford's business consisted of managing accounts in which the clients wrote put and call options. 3/ Stanford began

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1/ Section 206(4) and Rule 206(4)-1(a)(5) together in effect prohibit an investment adviser from publishing or circulating any advertisement which contains any untrue statement of a material fact or which is otherwise false or misleading.

2/ The hearing examiner also made findings with respect to allegations in the order for proceedings charging failure to make adequate disclosures in soliciting assignments of investment advisory contracts, to amend promptly the registration application, and to keep current books and records. We do not consider it necessary or appropriate on the basis of the record before us to reach these matters. Accordingly, we have determined to dispose of the proceedings solely on the basis of the issues with respect to Stanford's brochure and we do not make any adverse findings with respect to the other allega tions.

3/ A put is a negotiable contract in which the writer (seller) of the option, for a certain sum of money called the premium, gives the buyer of the option the right to demand within a specified time the purchase by the writer of a specified number of shares of a stock at a fixed (exercise or contract) price, generally the market price of the stock at the time the option is purchased. Similarly, a call gives the buyer of the option the right to demand that the writer sell shares at the exercise price. See Report on Put and Call Optio August 1961, p. 5, Division of Trading and Exchanges, Securities and Exchange Commission.

In a simple situation, a writer of a put is willing to acquire the underlying stock at a somewhat lower price than the current market price at the time of the contract, whereas the writer of a call is (Continued)

publishing a periodic newsletter advisory service, "Investing for Tomorrow's Profits," in July 1964, and about the same time it began distributing to new subscribers copies of its New Approach brochure, which undertook to furnish information about puts and calls and describe the selling of such options on a systematic basis as a desirable type of investment program. Although Ross conceded that the New Approach brochure had the tendency to advertise Stanford's services, respondents contend that it was not an advertisement, 4/ asserting that it was intended to inform persons how put and call options work. We reject this contention.

Stanford's name and address appeared at the bottom of the first page of the brochure and its name at the bottom of the remaining pages. The text of the brochure starts with the caption "Successful Investing - The Magic of Options" and asserts that successful option writing requires a specialized knowledge and investment management. It states that Stanford is believed to be the largest professional investment advisory organization offering aid to individual option writers and that its option writing service includes deciding what options clients should sell and the handling of all details of negotiation, analysis, bookkeeping and supervision for its clients, and notes that the one fee charged by it covers all of its expenses. 5/ It further states that a substantial amount of cash in a client's account "gives us complete freedom to accept any type of attractive option for your account," but that "ample opportunities exist ... to handle smaller management accounts with equal success" and that the minimum acceptable account is $25,000.

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3 Continued/ willing to sell such stock at a somewhat higher price than such market price. By writing a put or call at an exercise price equal to the current market price of the stock, the writer receives a premium which will reduce the cost of stock put to him or increase the price he receives for stock called from him. As against the premium which he receives, the writer restricts his freedom of action during the option period, since he has no control over the time when the option will be exercised, and also loses the opportunity to participate in any favorable market change in excess of the amount of the premium in the event the option is exercised. Frequently, the option in fact will not be exercised, in which case he keeps the premium without changing his investment position. There are, however, innumerable variations in methods of trading in options, each with its attendant risks and prospects, as indicated to some extent in our discussion herein.

There have been varying estimates of the extent to which options are exercised; the 1961 Report on Put and Call Options, supra, p. 45, states that of all options outstanding as of June 1, 1959 or written during June, 1959 and exercisable on or before January 31, 1960, 42 per cent were exercised.

4/ Rule 206(4)-1(b) defines advertisement to include any circular, letter or other written communication addressed to more than one person which offers any investment advisory service with regard to securities.

5/ Stanford's registration statement recites that the fee for advice regarding the sale of put and call options is $325 per year plus 1/2 of 1% of the net assets involved.

It is clear that the purpose as well as the effect of the brochure was to advertise the option account management services of Stanford. We conclude that New Approach was an advertisement for Stanford's advisory services within the meaning of Rule 206(4)-1. 6/

Respondents further contend that the brochure was not false or misleading, that its presentation of hypothetical examples of option transactions was not shown to be inaccurate or to misrepresent, that the examples are in fact similar to ones used to describe the mechanics of put and call options by recognized authorities in the field, and that the brochure included appropriate language cautioning the reader about the risks involved and the possibilities of losses.

We have previously taken action with respect to improper advertising practices of a number of investment advisers, 7/ and we again emphasize the importance of adherence to the required standards under the securities acts with respect to advertising not only by investment advisers but also by broker-dealers. We have frequently pointed out that advertising and sales practices which may or may not be suitable for products which are subject to actual inspection and testing in use clearly have no place in the sale of securities which are goods of an intricate, complicated and intangible nature. 8/ And put and call option contracts are securities of a most complicated and technical kind whose many intricacies and complex nature are not fully understood even by many persons engaged in the securities business itself, much less by the average or unsophisticated investor. Transactions involving puts and calls have substantial speculative aspects and entail significant risks of loss, and dealings in them are highly specialized and difficult. In such a field adherence to high standards of fair and accurate advertising is particularly important and especially in advertising by investment advisers, who hold themselves out as professionals who occupy a relationship of trust and confidence with their clients. 9/ While

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6/ Respondents in this connection also argue that the brochure was a business or financial publication within Section 202(a)(11)(D) of the Act, which excludes from the definition of "investment adviser" the "publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation." This argument does not aid respondents' position on the issues in the case. Section 202(a)'s function is to delineate who are and who are not investment advisers required to register, and Stanford in fact clearly was an investment adviser and was registered as such.

7/ Spear & Staff, Inc., Investment Advisers Act Release No. 188 (March 25, 1965); Marketlines, Inc., Investment Advisers Act Release No. 206 (January 20, 1967), aff'd sub nom Marketlines, Inc. v. S.E.C., 384 F.2d 264 (C.A. 2, 1967), cert. denied 390 U.S. 947; Dow Theory Forecasts, Inc., Investment Advisers Act Releases Nos. 219 and 223 (April 30 and July 22, 1968).

8/ Cf. Mac Robbins & Co., Inc., 41 S.E.C. 116, 117 (1962), aff'd sub nom Berko v. S.E.C., 316 F.2d 137 (C.A. 2, 1963); B. Fennekohl & Co., 41 S.E.C. 210, 216 (1962); Aircraft Dynamics International Corp., 41 S.E.C. 566, 570 (1963); Irving Friedman, Securities Exchange Act Release No. 8076, p. 5 (May 16, 1967).

9/ See S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 190 (1963); Dow Theory Forecasts, Inc., supra.

respondents' brochure did not have the flamboyant, highly exaggerated and dramatic character of certain other advertisements we have found in violation of the Act, we conclude that it failed to comply with the standards of the Act in that it improperly overemphasized and overstated the amounts and probabilities of gains and understated the risks and speculative elements involved.

The brochure, under the heading of "Profits in Option Writing," quotes from an article in a financial publication stating that in good years writers of options may realize as much as 50% on their capital, and if their funds are handled expertly they may net 20% even in less satisfactory years. It recites that option writing is a very complex subject which a writer can approach with several different methods, and six hypothetical transactions are presented which it states "will examine various situations from every possible angle." The hypothetical transactions involve sales of six-month options 10/ exercisable at the market prices of the underlying stock at the time the options are written and accompanied by stop-buy or stop-sell orders 11/ and, in some of the cases, by margined purchases or short sales of such stock. The brochure undertakes to examine the results on the alternative assumptions that the market price of the underlying stock in each example stays about the same or rises or declines in stated amounts during the option period.

For example, the brochure concludes that in the first two of the hypothetical transactions, involving a call and a put respectively, at the end of six months the writer would have a gain of either $200 or $500 on an investment of $3,000, and thus that the worst he could do over a period of a year would be to receive $400 or 13% on his investment, with a "very possible" gain of $1,000 or 33% on his investment, or an average gain of 23% per year over a period of years. In connection with another of the assumed transactions, involving the writing of a straddle, 12/ the brochure states that on an investment of $500 the writer at the end of six months would have a gain of either $500 or $1,000, and that on an annual basis the worst result would be a gain of $1,000 or 200% with a "possible" gain of $2,000 or 400%, and an average yield of 300% per year over a period of years. The other examples also showed outcomes with profits and "at the worst" break-even results.

After observing that the reader may wonder how close the hypothetical transactions come to reality, the brochure under the heading "Actual Experience with Options" describes four apparently risk-free option transactions stated to have been entered into shortly before by

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10/ The so-called "six month" option is typically for a period of six months and ten days, a period designed to permit the option buyers as well as sellers to realize long term gains for tax purposes in certain situations.

11/ A "stop" buy or sell order is an order to buy or sell only if and when the market price reaches the price specified in the order.

12/ A straddle is a combination of a put and a call giving the holder both the right to buy and the right to sell a specified number of shares of the same stock at a fixed price for a stated period of time. The holder may exercise either, both, or none of these rights.

local option writers. For example, the first such transaction described was the sale of a six months' call for 1,000 shares of a stock accompanied by the purchase of the stock at the $5 per share call price. The brochure states that if the call is exercised or the stock remains above the call price for the call period, the $1,125 in premiums received by the writer will amount on an annual basis to a 91% gain on an investment of $2,459. It also states that the stock would "have to drop below 3-7/8 before the writer could suffer any possible loss."

The brochure's emphasis on examples of successful options improperly minimized the risks involved. Although Ross in his testimony contended that an investor who continues in an option writing program over a period of some years will on the average make a profit, he admitted that some of Stanford's clients who discontinued their programs after a short period had various losses. As noted, however, the brochure discusses the hypothetical transactions in a manner which leads the reader to conclude that they generally produce an automatic and assured profit with not worse than a break-even in a few instances. The further statement that the examples would "work equally well in bull or bear markets" adds to the implication of mathematical certainty, as do the selected examples of recent actual options which also show either a gain or emphasize the ranges within which it is impossible for the writer to suffer any loss. The use of the over-simplified hypothetical examples, and the description of actual past transactions as "typical" carried with them the implication that adverse possibilities had been as fairly reflected as the favorable ones. A presentation of examples which does not fully disclose the risks involved in actual transactions is deceptive and misleading.

The hypothetical examples as set forth in the brochure do not in fact examine the situations presented from "every possible angle." In each case the brochure assumes that any change in the market price of the underlying stock during the option period will be either up or down, and ignores the possibility that the market price may go both up and down during that period, 13/ in which case the results may be worse for the option writer than those shown in the brochure.

Thus, in the first example in the brochure, the writer sells a six-month call on 100 shares at a call price of $50, the current market price of the stock, for a $500 premium. He simultaneously purchases 100 shares at 50, so that if the market price thereafter during the option period goes up to 60 or higher as assumed in the example and the option holder calls the stock, the writer delivers the stock he has purchased and has his profit in the $500 premium. In the example the option writer at the outset also enters a stop sell order at 47, so that if instead of going up the market price goes down to 40, alternatively assumed in the example, the writer's loss on the 100 shares he purchased is limited to $300, as his stock will be sold when the market reaches 47, and he will still be left with a net gain of $200 from his premium of $500. Thus the brochure concludes that "the worst" the writer can do is to gain $200, on an investment of $3,000 ($3,500 margin he would be required to deposit on his purchase of 100 shares at 50 less the $500 premium).

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13/ We note that the Report on Put and Call Options, supra, at p. 45 states that of all options sold in June 1959 on stocks listed on the New York Stock Exchange, more options were written on volatile stocks than on more stable issues and that half the option volume was in the 187 most volatile stocks traded on that Exchange.

But the situation can be worse for the writer if it is assumed that the market price first goes down so that the sell order is triggered at 47, and after his stock is thus sold but while the call is still alive, the market price goes up to 60 and the call is then exercised. In that event, the writer, no longer having stock in his possession, is faced with the prospect of acquiring another 100 shares in the market at 60 which he must deliver to the option holder at 50. At this point he would have suffered market losses of $300 on his earlier sale of 47 and $1,000 on his purchase at 60, plus expenses of four brokerage commissions totalling $176. Against these losses and expenses he would have received only the premium of $500, leaving him with a net loss of $976. Such a result is to be compared with the "worst" result envisaged by the brochure as a gain of $200, which the brochure further magnifies by optimistically projecting both such gain and the computed return on investment that it reflects on an annualized basis that implies an assured ability to obtain at least that gain and return repeatedly in successive option periods.

It may be noted from the above analysis that brokerage commissions incurred in buying and selling stock are a factor which must be accorded consideration in evaluating the prospects and amounts of gain in the option writing program. When an option is exercised the writer pays the regular stock exchange commission on the purchase or sale transaction; if as a part of his program he has also acquired a position in the stock underlying the option he pays the regular commission on that transaction too. The examples make no mention of the commissions involved. Although the brochure states that "In most cases, enough leeway has been left in rounding to compensate for commissions," an analysis indicates that there was not sufficient allowance for such commissions in examples 1, 2 and 6.

As in the case of the first example, each of the other hypothetical transactions presented in the brochure ignores the possibilities of dual or multiple adverse market movements during the option period. In each, in the absence of further actions by the writer which are not included in the assumed transactions, the writer could have either an actual loss, or an unrealized loss with part of his capital tied up in holding stocks he had no interest in owning or as margin against a short sale with the result that his ability to write additional options might be adversely affected.

We do not mean to say that the market possibilities presented in the analysis we have outlined above are more likely to be representative than the situations described in the brochure. But even if less representative, the brochure, as an advertisement of an investment adviser soliciting customers, should nevertheless have taken them into account.

The brochure also overemphasizes the favorable results that could be realized in the six hypothetical transactions by assuming the applicability of minimum margin requirements on options. While it notes that some brokerage houses have their own "house rules" requiring larger

deposits, the examples were worked out on the basis of the minimum margins then permitted by the rules of the New York Stock Exchange, namely, 30% of the market value of the underlying stock in the case of a call or a straddle and 25% of the market value of the stock in the case of a put. 14/ Furthermore, the hypothetical transactions did not take into account the additional amounts which the writer would be required to deposit to maintain his initial margin position as market prices of the stock fluctuate.

Further, the examples make no allowance for dividends on the underlying stock during the option periods. If the option writer is not long the stock against which he writes a call or is not short the stock against which he writes a put, the declaration of dividends during the option period may affect the amount and percentage return on investment upon the exercise of the option. The brochure in a note states that dividends in some cases will go to the option writer while in other cases they will go to the optionholder, depending on whether or not a call is exercised. Nevertheless the possibility that and extent to which the option writer's return on a call option could be decreased by the dividend adjustment should have been set forth in the examples themselves.

We cannot agree with respondents that the brochure adequately cautioned readers about the possibilities of loss and the risks involved in option writing. The brochure does include a statement that "while these [hypothetical] examples closely parallel the normal maneuvers of successful option writers, actual results may vary in degree from the examples shown. Obviously, no representation is made that these gains will always be obtained in actual practice." This caveat, however, was the ninth note in a series of ten notes following the hypothetical examples, and none of the other notes pertained to the risks involved. Moreover, although a subsequent section entitled "Some Risk Involved" states that option writing is not "a fool-proof method of investing" and describes several ways in which an option writer could suffer a loss, such as from placing stop orders too close to the market so as to run the risk of "whipsaws" from small price fluctuations, this is followed by a section headed "Minimizing Loss" which states that "Even when the option writer makes a mistake there are various definite steps which can be taken to minimize a loss." 15/ The brochure also asserts

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14/ The standard option contract provides that the option must be endorsed or guaranteed by member firms of the New York Stock Exchange. The Report on Put and Call Options, supra, p. 59, states that more than half of the 126 exchange firms which endorsed for others options outstanding during June 1959 required the writers to deposit more than the minimum margins.

15/ The transactions that are set forth to clarify this statement cover only one type of situation, that in which a writer, who has sold a call option, purchases the underlying stock to protect himself against a potential loss through a rise in the market price of such stock, and instead of rising the price of the stock falls. The fall in the price of the stock would then leave the writer with an unrealized loss which the brochure states can be minimized by the writer selling additional call options on the stock, with the premiums reducing the writer's potential loss. Aside from the fact that this technique might not be helpful in other situations, it assumes that the option writer will be able repeatedly to sell call options on a stock when its price is falling substantially over an extended period of time.

that investment management is essential for option writing success and that an individual investor would be faced with a number of problems and risks which could be largely eliminated by utilizing Stanford's investment counseling services. 16/ In our opinion these statements do not suffice to overcome the implication of certainty of substantial profit implicit in the specific examples discussed in detail in the brochure. Rather they serve to further deemphasize the possibilities of loss (provided Stanford's services were used) and by implication increase the expectation of an unsophisticated reader that Stanford's guidance would assuredly enable him to reproduce the results shown in the examples. 17/

We find that the over-all effect of the brochure was to give a misleading impression of the probability of gains to be achieved in the selling of options under Stanford's guidance and of the unlikelihood of losses, 18/ and that its use was contrary to the standards of the Act.

## Public Interest

The Act confers upon this Commission and the Courts the authority to determine whether an investment adviser's literature conforms with the high standards imposed in this area, and commercial publications cannot by their practices establish lower standards. 19/ We recognize, however, that Stanford's brochure was patterned in large part upon existing publications relating to options which typically present hypothetical examples of profitable option transactions, project the possible gains on an annual basis, and contain generalized statements and assumptions as to the impact of brokerage commissions, dividends and margin requirements. In addition the brochure did contain, as noted, various caveats with respect to risks and the possibilities of loss which however, again like other literature pertaining to options, tended to minimize the adverse possibilities. We further note that these are the first administrative proceedings to come before us involving the adequacy of such literature relating to puts and calls, respondents' representation that they discontinued the solicitation of option writing accounts before the institution of these proceedings, and their report that they have not been active as investment advisers for a substantial period of time. Under all the circumstances, particularly the fact that this is the first occasion on which we have addressed ourselves to these matters, we conclude that censure is an adequate sanction.

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16/ Since stocks on which options are traded may well be violatile (see note 1, p. 11, *supra*), fluctuations in the market prices of such stocksmay make it necessary for the writer to give close and continuing attention to price changes and make complicated decisions involving among other things frequent and properly timed revisions of conditional buy and sell orders to minimize or avoid losses.

17/ *Cf*. *Spear & Staff, Inc.*, *supra*, where at page 5 we stated that in appraising advertisements "we do not look only to the effect they might have had on careful and analytical persons. We look also to their possible impact on those unskilled and unsophisticated in investment matters." See also *Marketlines, Inc.*, *supra*.

18/ In a section entitled "Odds Against the Option Buyer," preceding the discussion of the possibilities of profits in option writing, the brochure pointed out some of the adverse factors involved in the buying of options, thus further adding to the overemphasis of success in the selling of options.

19/ See *Marketlines, Inc.*, *supra*, p. 4.

We wish to reiterate however, the importance that we attach to the requirement that investor materials relating to options, which as noted involve securities transactions of a complex nature, be written in a manner that will not mislead investors, and we wish to note that we shall expect the industry to undertake promptly a careful review of all the materials relating to options, which are now made available to investors or are to be used in the future, in the light of the factors discussed in this opinion and all other pertinent considerations bearing upon their accuracy, clarity and fairness of disclosure. In future cases we shall consider any failure to adhere to the highest standards of fair dealing, in advertising disclosure and otherwise, a basis for the imposition of more severe sanctions.

Other Matters

We cannot find as respondents contend that they were denied due process in these proceedings. That the hearing examiner failed to refer to certain defenses and evidence introduced by respondents and stated as factual certain matters not supported in the record (but which are not necessary to our disposition of the case), does not indicate, as claimed by respondents, that he was biased or prejudiced against them or lacking in objectivity. Nor can we find that respondents were prejudiced by the examiner's rejection of certain publications relating to puts and calls offered in evidence by respondents. As the examiner pointed out, such publications were available for use by respondents in their arguments and briefs, and we have taken note of them in reaching our conclusions herein. We also cannot find that the provisions of the Act and of the rules issued thereunder are so vague as to deprive respondents of due process as they contend. As the administrative agency delegated by Congress to administer the Investment Advisers Act, we necessarily proceed on the assumption that such Act is constitutional unless and until the courts declare otherwise. 20/ Although it is not our function to pass on the constitutionality of our governing acts, 21/ we do note that findings of violations based on sections in issue herein have been upheld in the courts. 22/ Finally, we do not see how respondents were prejudiced in these proceedings by the fact that an employee of a broker-dealer testified that he had heard that our staff was making an inquiry or an investigation with respect to respondents. 23/

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20/ Mutual Fund Distributors, Inc., 41 S.E.C. 174, 181 (1962); J.A. Sisto & Co., 7 S.E.C. 647, 653 (1940); Walston & Co., 5 S.E.C. 112, 113 (1939).

21/ Engineers Public Service Co. v. S.E.C., 138 F.2d 936, 953 (C.A.D.C., 1943); Panitz v. District of Columbia, 112 F.2d 39 (C.A.D.C., 1940); Houston Natural Gas Corporation, 3 S.E.C. 664, 671 (1938); see also McClane & Co., Inc., Securities Exchange Act Release No. 7227 (January 29, 1964).

22/ See, for example, Marketlines, Inc. v. S.E.C., supra; S.E.C. v. Capital Gains Research Bureau, Inc., supra.

23/ Section 210 of the Act provides that no member, officer or employee of this Commission shall make public the fact that any examination or investigation is being conducted under the Act, subject to our right to institute public proceedings in appropriate cases. There is no evidence that any Commission member, officer or employee disclosed the existence of any investigation of respondents contrary to Section 210; we and our staff, of course, cannot control and are not responsible for the act of any person who is interrogated or who is a witness in any examination or investigation.

We have considered all of the exceptions to the initial decision of the hearing examiner and they are overruled, or sustained, to the extent they are inconsistent, or in accord, with our findings and opinion herein.

An appropriate order will issue.

By the Commission (Chairman COHEN and Commissioners OWENS, BUDGE, WHEAT and SMITH).

Orval L. DuBois
Secretary