May 9, 2022

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The Americans for Financial Reform Education Fund appreciates this opportunity to comment on Financial Industry Regulatory Authority (FINRA)'s oversight of its member brokerage firms and the complex investment products they offer. We have found significant evidence of the losses retail investors have suffered accessing these complex investment products.

More investors have access to complex investment products that can lead to unexpected losses

The growth of retail brokerage firms has significantly expanded the access to lower-cost trading and stock market ownership in households, with a record 41.5% of household financial assets invested in the stock market in 2021. This now exceeds the 37% high in 1999 and well above the 18% low after the Great Financial Crisis in 2008.[1] Since 2019, brokerages such as Robinhood grown to 22.8 million from 5.1 million in 2019.[2]

With a greater number of brokerage accounts, we have seen increased access to options trading. As FINRA has found, listed options trading now averages around 38.6 million contracts per day, nearly 200% more than the 19.8 million contracts a day that were traded in 2019.

Unlike investing in a stock, options are leveraged bets on the direction of a stock price, but studies by the Chicago Board Options Exchange (CBOE) found that about 30% of options on stocks expire with no value remaining.[3]

While investors losing money is nothing new, investors who are unfamiliar with options are at risk of losing significant amounts of their net worth in a short period of time.

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[1] Cox, Jeff. CNBC. Stocks are at a 70-year high as a share of household financial wealth. Oct 1, 2021. https://www.cnbc.com/2021/10/01/stocks-are-at-a-70-year-high-as-a-share-of-household-financial-wealth.html
[2] Securities and Exchange Commission EDGAR. 8-K: Current report. Apr 28, 2022. https://www.sec.gov/ix?doc=/Archives/edgar/data/0001783879/000178387922000088/hood-20220426.htm
[3] McMillan, Lawrence G. McMillan on Options, Second Edition. Oct 4, 2004.

One 35-year-old psychiatrist recently lost $1 million, or his entire life's savings, buying out-of-the-money call options for $25/share on a Special Purpose Acquisition Company (SPAC) Pershing Square Tontine Holdings that were trading at $23/share before the "blank check company" found a company to reverse merge with.[4] The psychiatrist now cannot afford to repay his remaining $350,000 in student loans saying, "I considered this a safe, calculated bet," a view shared by 16 people who also lost money.[5]

Options strategies have enabled unsophisticated retail traders to lose greater than their initial investment

A number of strategies involving options pose significant danger to an investor's capital as some positions have gone as far as to cause investors to lose more than they initially invested. This is because brokers allow retail traders to enter into complex multi-prong options where each leg is many multiples the size of the investor's initial total investment, but because various positions offset each other in case of extreme price moves, brokers allow investors to borrow that additional money and take on that risk.

However, this strategy misses the extremely dangerous risk that one prong of the multi-leg options strategy gets exercised early, suddenly leaving the investor with a significantly unprotected position many times larger than their initial investment. While this kind of risk may be tolerable to certain prepared investors, almost any retail trader can obtain access to such options strategies with little to no additional verification by the broker of their understanding or qualifications.[6]

The consequences have been very painful for several investors who were caught by surprise by unexpected movements in series of stocks they purchased options on.

One example is from a user named "1R0NYMAN," who shared on the internet message board Reddit's WallStreetBets sub-forum, their use of a box-spread options strategy.

Under the strategy, 1R0NYMAN:

- Purchased a bull call spread (buying a call option with a certain strike price while selling another call with a higher strike price)
- Attempted to capture the difference between the two options for an estimated gain of anywhere between $40,000-$50,000
- Was very confident in the trade that he told others on the forum "I have no money at risk"

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[4] Celarier, Michelle. Institutional Investor. How Millennial Investors Lost Millions on Bill Ackman's SPAC. Aug 11, 2021. https://www.institutionalinvestor.com/article/b1t353k8yyfr5w/How-Millennial-Investors-Lost-Millions-on-Bill-Ackman-s-SPAC

[5] Id.

[6] Morrow, Allison. CNN Business. Everything you need to know about how a Reddit group blew up GameStop's stock. Jan 28, 2021. https://www.cnn.com/2021/01/27/investing/gamestop-reddit-stock/index.html

However, 1R0NYMAN did not expect that the owner of the options he was selling would get exercised, meaning that as an options seller, he was suddenly on the hook to deliver shares of stock that he was not prepared to. In response, his brokerage Robinhood, ended up having to sell the remainder of his call options.

Such a debacle ended up losing 1R0NYMAN more than the $5,000 he put into the trade. While investors typically believe that in an absolute worst case scenario, they lose 100%, because of all the additional capital 1R0NYMAN had to borrow to put on this multi-leg box-spread options trade, when all was said and done, the suddenly different position and risk profile instead lead him to owe an additional $50,000 or a loss of-1,832% due to a $54,989 loss on an original $5,000 trade.[7]

In all, it is estimated that retail investors lost over $1 billion trying to day trade options over the course of the pandemic.[8]

This trading activity often resembles gambling more than investing, like the more than 50,000 out-of-the-money call options purchased in February 2021 on the stock price of GameStop multiplying by seven times only hours before the options would expire. Those options did so, expiring worthless the next day, leading to those buyers to lose all of their money.

Clearly FINRA should work with brokers to accurately assess their investors' understanding of the various scenarios in which a complex investment product would gain or lose money before allowing them to do so.

Leveraged ETFs perform very differently than how they are marketed

Leveraged ETFs, which allow investors to magnify their exposure to short-term movements in certain baskets of securities, often deviate greatly from the underlying instruments and lose their value over time.

Many retail investors continue to be unaware that leveraged ETFs only magnify the <u>daily</u> returns of the portfolio the ETF tracks and not their performance over a longer period of time. Mathematically, a large loss, which is possible in leveraged ETFs with triple leverage, must be made up by an even larger gain. Put another way, a 50% loss in an ETF does not get back to even with a 50% gain, but rather a 100% gain.

This example also plays out in a more subtle but over time significant way in leveraged ETFs.

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[7] Langlois, Shawn. MarketWatch. Trader says he has 'no money at risk' then promptly loses almost 2,000%. Jan 22, 2019. https://www.marketwatch.com/story/trader-says-he-has-no-money-at-risk-then-promptly-loses-almost-2000-2019-01-22

[8] Hajric, Vildana. Bloomberg News. Mom and Pop Investors Took a Billion-Dollar Bath Trading Options During the Pandemic. Apr 27, 2022. https://www.bloomberg.com/news/articles/2022-04-27/mom-and-pop-took-a-billion-dollar-bath-trading-pandemic-options

For example, in a 3x leveraged long ETF of the S&P 500 with a balance of $100:

- A 1% daily gain in the S&P 500 on a $100 balance would lead to a 3% ($3) return for the ETF holder.
- A 2% decline in the S&P 500 on the next day, would lead to a 6% loss in the ETF (-$6.18) leaving a portfolio value of $96.82.
- If on the third day the S&P 500 were to reverse the prior day's losses and gain 2%, the portfolio would be worth $102.60.

Although the leveraged ETF declined by 2% on the second day, it is not recovered from the ETF gaining 2% the following day, as the gain is done on a lower base leading to a balance of $102.60 versus $103 at the beginning of the second day.

Many market commentators have pointed out that for these reasons, over the long run leveraged ETFs will lose their value and "are very likely to burn a hole in your portfolio".[9]

Conclusion

With a greater number of households opening brokerage accounts, with which they have access to publicly traded complex investment products, FINRA should work with its member organizations to ensure that greater safeguards are in place for novice investors to avoid losing significant amounts of their capital.

For questions, please feel free to contact Andrew Park at andrew@ourfinancialsecurity.org.

[9] Kahn, Michael. Kiplinger. Run, Don't Walk, From Leveraged ETFs. Mar 5, 2018. https://www.kiplinger.com/article/investing/t022-c009-s001-run-don-t-walk-from-leveraged-etfs.html