OCC THE FOUNDATION FOR SECURE MARKETS

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BY EMAIL

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
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Re: Regulatory Notice 22-08 – Complex Products and Options

Dear Ms. Mitchell:

The Options Clearing Corporation ("OCC") appreciates the opportunity to comment on FINRA's release soliciting comment on effective sales practices and rule enhancements concerning complex products and options. OCC believes that the current model for ensuring that investors understand options before entering into options trades—robust broker-dealer account opening requirements, comprehensive disclosures, and a wealth of educational material made available to individual investors—is a sound one that has served the options industry and its participants well. OCC welcomes FINRA's efforts to understand and disseminate best practices within the industry. OCC further welcomes and encourages efforts to provide investors with disclosures and education about the responsible use of options in the most accessible form. In addition, this letter also addresses two of the specific questions FINRA raises in the Regulatory Notice: (1) whether broker-dealers should be required to provide specific disclosures to customers in addition to delivery of the "Characteristics and Risks of Standardized Options," also known as the "Options Disclosure Document" ("ODD"), and (2) whether FINRA should enhance its rules concerning exercise cut-off times to address potential expiration risk associated with certain trading strategies that involve purchasing and selling options on the same underlying.

I. About OCC

Founded in 1973, OCC is the world's largest equity derivatives clearing organization. OCC clears all standardized options listed on the sixteen U.S. national securities exchanges that trade options subject to the jurisdiction of the Securities Exchange Commission ("SEC"), and clears commodity futures and commodity options for two U.S. futures exchanges subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC"). OCC also provides central counterparty clearing and settlement services for securities lending transactions. OCC is registered with the SEC as a clearing agency pursuant to Section 17A of the Securities Exchange Act of 1934,[1] is registered with the CFTC as a derivatives clearing organization ("DCO") pursuant to Section 5b of the Commodity Exchange Act,[2] and is designated by the Financial Stability Oversight Council as a systemically important financial market utility ("SIFMU"). As a SIFMU, OCC is also subject to oversight by the Board of Governors of the Federal Reserve System. OCC operates as a market utility, is owned by five options exchanges, and is governed by a Board of Directors comprised of clearing member, exchange, and public directors.

II. Background

Exchange listed options products have been traded for almost 50 years. Although the market structure has changed drastically over that period, and numerous options contracts have been listed, the underlying and inherent risks associated with options trading have not changed materially over time. Accordingly, as the marketplace has evolved, several important options-specific investor protections have been put in place by regulators and SROs. Specifically, the industry employs three primary means for ensuring investors understand options before entering into options trades: disclosures, account opening and suitability requirements, and education.

Broker-dealers are required to deliver the ODD to their customers before accepting options orders.[3] OCC prepares the ODD jointly with the option exchanges and submits proposed revisions to the ODD to the SEC prior to publication.[4] As described in more detail below, the ODD covers the characteristics and risks of listed options generally, as well as each type of option product offered on one or more of the option exchanges. Accordingly, the ODD has expanded in length over time as exchanges have developed and listed new products.

Pursuant to SEC regulations and FINRA rules, broker-dealers also must approve or disapprove the opening of a customer account specifically for the purpose of trading options. A broker's determination that options trading is appropriate for a customer must be based on the suitability reviews a broker is required to perform prior to determining investments appropriate for a customer. These reviews include reviewing personal financial information, including net worth, income, and employment information; investment objectives; and investment knowledge and trading experience, and must be made for both self-directed and advised accounts. Moreover, options accounts also are subject to broker supervisory reviews, which include brokers reviewing whether options transactions are compatible with the customer's investment objectives. We note that brokers

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1 15 U.S.C. § 78q-1.

2 7 U.S.C. § 7a-1.

3 See 17 CFR 240.9b-1(d); FINRA Rule 2360(b)(11)(A)(i). In addition to requiring that broker-dealers deliver the ODD, OCC notes that FINRA Rules require broker-dealers to deliver a copy of the "Special Statement for Uncovered Options Writers" to customers with an account approved for writing uncovered short options. See FINRA Rule 2360(b)(11)(A)(ii).

4 Revisions to the ODD are published after 30 days of providing them to the SEC or earlier if the SEC approves the changes. New products that may be the subject of ODD revisions are also subject to SEC approval of any necessary changes to the rules of the listing exchanges and/or OCC.

are subject to periodic regulatory examination where brokers may be required to demonstrate that they have appropriately conducted suitability reviews of clients approved to trade options.

Finally, a wealth of information about option trading is available to investors, including, for example, options education provided by OCC's educational arm, the Options Industry Council ("OIC"), discussed in detail below. The options exchanges and broker-dealers have significant educational offerings as well. For example, Cboe offers options education through The Options Institute.[5] It is in the interest of OCC, exchanges, and broker-dealers to ensure retail investors who trade options are aware of the benefits and risks. OCC believes that these means—disclosures, account requirements, and education—provide a strong foundation and work in tandem to ensure that customers are fully armed with adequate knowledge and are suited to trade options.

II. Current Practices Designed to Inform and Educate Investors

Regulatory Notice 22-08 solicits comment on whether broker-dealers should, in addition to providing customers with the ODD, be required to provide customers with a "simple, perhaps one single page, disclosure document that focuses on the key risks of trading options." OCC is strongly committed to modernizing options disclosure to make it more useful and engaging for investors. In this effort, we have developed and will launch soon an interactive module—the "ODD Quick Guide"—to help investors navigate the sections of the ODD. Beyond that, we strongly encourage and support efforts to provide investors with education about the responsible use of options in the most accessible forms, and as such will continue to partner with FINRA, the SEC and the industry to create continually improved educational offerings. To this end, OCC believes it is important to highlight in more detail the existing resources afforded to options market participants and potential investors.

A. Disclosure Documents

ODD

As the issuer of all listed options, and jointly with the options exchanges, OCC administers the ODD, which explains the characteristics and risks of exchange-traded options.[6] As prescribed by SEC Rule 9b-1,[7] the ODD contains:

- the identity of OCC as the issuer of all listed options and the identity of the markets on which those options trade;
- a glossary of standardized terms and special vocabulary applicable to options;
- a general identification of the types of instruments underlying the options classes covered by the documents (e.g., options on equity securities, index options, flexibly structured options, etc.);

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5 See https://www.cboe.com/optionsinstitute/.

6 See https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document.

7 17 CFR 240.9b-1.

- a discussion of the mechanics of exercising options;
- reference to transaction costs, margin requirements and tax consequences of options trading; and
- a discussion of the principal risks of being a holder or writer of options, special risks related to particular classes of options, and other risks related to transactions in listed options.

As FINRA noted in its 2020 Investor Insight, a joint publication with OCC, "Trading Options: Understanding Assignment" ("Investor Insight"), "[t]he options market can seem to have a language of its own."[8] The ODD is structured in such a way that it provides an introduction to options and options "nomenclature," i.e., standardized and special vocabulary particular to options trading, prior to describing additional detailed information related to trading options based on any specific underlying instrument. The ODD cautions recipients to read and understand the ODD in its entirety; the first portion of text describe basic options concepts, define terms, explain certain aspects of the options markets, and provide numerous examples that help the reader put these terms and concepts into context.

In 2021, OCC published a restated ODD that made the ODD more user-friendly. Prior to this effort, the ODD was comprised of a version dated February 1994 with fourteen supplements added from 1997 through 2018. Those supplements set forth marked changes to specific material in the February 1994 ODD or material in subsequent supplements. The restated ODD incorporates all prior supplements and amendments into the text of the ODD, thereby eliminating the need for a reader to navigate between original text and supplements. Going forward, OCC will continue to amend the text of the ODD itself, as it did most recently in March 2022, in lieu of adding supplements. OCC believes the updates materially enhanced the reader's ability to understand the ODD's content.

Key Information Documents ("KIDs")

OCC also publishes Key Information Documents ("KIDs"), which are disclosures required under EU regulations for packaged retail and insurance-based investment products ("PRIIPs"), a category that includes the options and futures products cleared by OCC. A person providing advice about or selling a PRIIP to an EU retail investor is required to deliver a copy of the relevant KIDs to the investor in advance of the purchase or sale. KIDs are intended to provide EU retail investors with a product overview and risk assessment and are presented in a standardized form prescribed by regulation, which includes a provision that KIDs be a maximum of three pages long. In order to support members with EU customers, OCC has prepared a series of KIDs that are both product-based (e.g., equity options, index options, index futures, etc.) and position-based (e.g., long or short and, with respect to options, put or call).[9] For each product and position, OCC's KIDs include information on:

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[8] Trading Options; Understanding Assignment (Dec. 14, 2020), https://www.finra.org/investors/insights/trading-options-understanding-assignment, itself a three-page document focusing solely on assignment risk.

[9] See https://www.theocc.com/Company-Information/Documents-and-Archives/Key-Information-Documents-English.

- the types of investors for whom the product is intended;
- the risks and reward profile of the product, including a summary risk indicator, the possible maximum loss of invested capital, and appropriate performance scenarios of the product;
- the costs investors must bear when investing in the product; and
- information about how and to whom an investor can make a complaint in case there is a problem with the product or the person producing, advising on or selling the product.

While shorter than the ODD, each KID focuses on a narrow product, e.g., a long equity call, a short equity call, or a long index put. By comparison, the ODD covers a broader range of terms and concepts, as well as all types of options products, thus lengthening with each new product created and listed.

B. Education

In addition to publishing disclosures documents, OCC also provides a variety of options educational resources to the public about the prudent use of the products OCC clears. To this end, OCC and the options exchanges operating at the time created OIC in 1992 as an industry resource dedicated to helping retail investors, financial advisors, and institutional investors understand the benefits and risks of listed options through educational content. OCC provides a dedicated investor education team to support these efforts and assumed full funding responsibility for OIC in 2017. OCC Investor Education and the OIC deliver significant options educational content, at no cost to the public, through a comprehensive website that features interactive courses, live chat, podcasts, webinars, trading tools, and videos.[10]

The OIC website content includes information related to options basics, leverage and risk, exercising options, spread trading, hedging, the ODD, Greeks, and an options strategies quick guide. It also includes descriptions of nearly fifty different option strategies,[11] including the vertical spread strategies that are the focus of Regulatory Notice 22-08's solicitation of comments on potential enhancements to FINRA rules concerning options exercise cut-off times. In addition to a description of how each strategy is constructed, such descriptions include:

- the strategy's outlook with respect to the underlying interest (e.g., bearish, bullish, neutral);
- the primary motivations for pursing the strategy (e.g., to hedge long stock positions, to earn premium income, etc.);
- the maximum potential gain and loss;
- potential for profit and loss and the breakeven point;
- the potential effect of changes in implied volatility on the strategy;
- the potential effect of time decay on the options strategy;

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10 See https://www.optionseducation.org.

11 See https://www.optionseducation.org/strategies/all-strategies-en.

- the potential risk of assignment for the strategy; and
- the potential risks at expiration.

Through these free resources, OIC offers investors information about the benefits and risks of listed options. Over the course of its 30-year existence, OIC offerings have been tailored towards many different learning styles and investing skill levels. Through OIC's engaging online tools, all market participants and investors, regardless of experience, can build and expand their options acumen.

III. Options Exercise Risks

Regulatory Notice 22-08 also seeks comments on whether to revise FINRA Rule 2360(b)(23) so that all option holders would have until 5:30 p.m. ET on the day of expiration, or in the case of a standardized equity option expiring on a day that is not a business day,[12] on the business day immediately prior to the expiration date, to make a final decision to exercise or not exercise an expiring option. Currently, FINRA Rule 2360(b)(23) provides that members may not accept exercise instructions after 5:30 p.m. Eastern Time, but members may establish their own earlier cut-off times by which customer exercise instructions are due. To the extent there is member consensus that a universal 5:30 p.m. cut-off time for customers to submit exercise instructions will continue to allow members to meet their SRO submission deadlines and is not overly burdensome, i.e., members can reasonably continue to meet the SRO deadlines for submission given existing systems and staffing, OCC sees tremendous benefits to reducing investor confusion and helping to ensure that all investors have the same amount of time to make exercise decisions up to a universal 5:30 p.m. cut-off time.

In requesting comment on whether all customers should have until 5:30 p.m. to submit exercise instructions to their member firms, FINRA referenced the Investor Insight, which highlights potential risks associated with late exercises. More specifically, the Investor Insight provided two examples whereby market-moving news was released after the close of trading that had the potential to cause long option holders to make decisions to exercise options that would not have been attractive to exercise at the end of day closing price. If, as posited by FINRA, all investors have the ability to submit exercise or contrary exercises notices to their brokers up to 5:30 p.m., investors holding spread positions could take defensive steps to mitigate assignment risk by having the ability to submit exercise or contrary exercise notices themselves. As it stands now, however, given that member firms may have different internal cut-off times, that might not be the case.

Presumably, the regulatory provision allowing member flexibility with respect to members' "internal" exercise instruction cut-off times was established in order to give broker-dealers that had

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12 Until the listed-option industry transitioned to Friday expirations for most standardized options, expirations historically occurred on Saturdays (i.e., not a business day). OCC Rules concerning expirations on days other than business days were retained to address grandfathered contracts in existence at the time of that transition, the longest dated of which extended through December 18, 2021. OCC Rules concerning expirations on days other than business days remain relevant to contracts with expiration dates that were listed prior to that expiration date becoming a national holiday (e.g., Juneteenth National Independence Day). See OCC Info Memo #49718 (Dec. 8, 2021), available at https://infomemo.theocc.com/infomemos?number=49718.

to compile and prepare potentially large numbers of customer exercise instructions adequate time to allow them to meet their regulatory deadlines for submission to the SROs. As the industry has evolved to a largely electronic environment, the need for earlier member established internal customer cut-off times appears to have been muted. Furthermore, the SROs provide members with additional time after the 5:30 p.m. cut-off time to submit certain exercise instructions to the SROs, provided certain conditions are met.[13]

OCC stresses that even with a level playing field for customers with respect to exercise submission cut-off times, expiration risk is an inherent feature of certain option trading strategies if maintained to expiration, including the spread strategy examples discussed in the 2020 Investor Insight.[14] Because assignment occurs after exercise, investors will not be certain whether they will be assigned a contract prior to the time they must make an exercise decision for an expiring option. Option writers do not learn whether they have been assigned an exercise until the next day, which, in the case of a standard Friday expiration, generally would be the Monday morning of the following week. Acting on a guess as to whether a position will be assigned has potential risks either way if the guess proves wrong. As the OIC description of expiration risk associated with various vertical spread strategies explains, there are two ways to prepare: (1) close the spread out prior to expiration, or (2) be prepared for either outcome on Monday.[15] Either way, it is important for investors engaged in any multi-leg option strategy to monitor the stock closely, especially over the last day of trading. Importantly, OCC also must accept all exercises it receives prior to expiration, regardless of whether exercises are filed with OCC in violation of an options exchange's exercise submission rules. Although a combination of OCC fees and SRO regulatory fines are intended to discourage late submissions, late submissions are possible.

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OCC appreciates the opportunity to comment on FINRA Regulatory Notice 22-08. OCC encourages efforts to provide investors with education about the responsible use of options in the most accessible form. As discussed above, OCC believes that the robust regulatory framework around suitability assessments specific to options has benefitted investors. In fact, the approach may prove useful in the framework for other complex products. Current disclosure and investor education resources work together to help investors understand the features and risks inherent in options before they enter the market. OCC is committed to continuing to produce engaging investor education content and invest significant resources in its efforts while providing all developed content to investors free of charge. Likewise, OCC continues its efforts to modernize and enhance the usefulness of options disclosure for investors and is committed to working with the SEC, FINRA and the listed options industry to identify approaches to best accomplish this critical deliverable. Lastly, OCC supports efforts to promote awareness of assignment and expiration risks, and to make the expiration process equitable for all investors.

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[13] See, e.g., FINRA Rule 2360(b)(23)(A)(iv) allowing members to submit contrary exercise instructions up until 7:30 p.m. ET, if such member employs an electronic submission procedure with time stamp for the submission of exercise instructions by option holders.

[14] See note 8, supra.

[15] See, e.g., Bear Put Spread, https://www.optionseducation.org/strategies/all-strategies/bear-put-spread.

Very truly yours,

Joseph P. Kamnik
Chief Regulatory Counsel