May 9, 2022

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Submitted via email pubcom@finra.org

Re: *Request for Comment on Regulatory Notice 22-08: Sales Practice Obligations for Complex Products and Options*

Dear Madam:

The undersigned attorneys general submit this comment in response to the Financial Industry Regulatory Authority ("FINRA")'s Request for Comment Regarding Sale Practice Obligations for Complex Products and Options ("the Notice").[1]

Introduction

The states we represent have a significant and longstanding interest in protecting the savings of their residents, in assuring the opportunity to plan for retirement and other needs, and in securing independence, including financial independence, from the designs of those who may not have our residents' best interests at heart. For these reasons, our states have long required schools to ensure financial literacy among their students, offered adult financial education, and undertaken many other efforts to promote the ability of our residents to successfully take the driver's seat on their financial decisions.

A technological development that has significantly helped us meet these objectives has been the growth of self-directed trading platforms, which allow individual retail investors to take actions themselves ("Investor Access") that formerly they could take only through third parties, such as brokers. The availability of these platforms has given our residents greater control of their financial lives, allowed many to achieve higher returns, and exerted beneficial competitive effects on financial professionals.

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[1] Regulatory Notice 22-08.

By threatening to block Investor Access to certain kinds of investment products (which FINRA admits are undefined),[2] FINRA imperils these objectives. To read the Notice, one would think that Investor Access is only dangerous; the Notice offers nothing—and no questions to ask—about the many benefits that Investor Access offers.

FINRA's myopic focus on harms is irrational and unlawful—especially in light of the mandate, imposed by Congress and applicable to FINRA just as it is to the SEC, to consider the efficiency and competition that these platforms promote. FINRA's clear communication in the Notice that it regards Investor Access as only a threat will discourage commenters from submitting comments with the sort of information that could change FINRA's mind; this will taint any subsequent proposed rules with prejudgment. A hallmark of sound rulemaking is properly framing the issue for commenters, before adopting a final rule.[3]

This lack of proper framing would be bad enough if FINRA were a neutral third-party regulator. But, of course, it is not: FINRA is composed of the very investment professionals who would benefit by reducing direct Investor Access to valuable investment tools. The Notice accomplishes its professional protectionism through investor paternalism—and the latter is just as unlawful as the former, for the central premise and goal of the Securities Exchange Act is that investors can manage their own investments, and ought to be allowed to do so. The Securities Exchange Act is meant to protect investors from unscrupulous traders and brokers, but not prevent them from managing their own investments.

Moreover, the Notice's approach, if made the basis of a final rule, would be arbitrary and capricious under the Administrative Procedure Act. First, it fails to define, or even meaningfully clarify, the key term on which its entire approach turns—and then ignores the costs of the confusion it creates. That is unreasonable and also raises vagueness concerns under the Constitution's Due Process Clause. Second, the Notice fails to demonstrate that there is a problem in need of fixing, instead assuming the answer to what should be the most important empirical question in play: are retail investors in fact confused about the products they trade? Finally, even if the Notice identifies a problem, it has not shown that top-down federal action is needed to solve it. The States, with their longstanding financial literacy and education programs, are far better positioned to remedy any problem while continuing to foster the invaluable benefits of Investor Access.

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[2] *See id*., "Background and Discussion," ("There is currently no standard definition of a "complex product' . . . FINRA [has] refrained from defining "complex product").

[3] *See National Lifeline Association v Federal Communication Commission*, 921 F.3d 1102, 115 (D.C. Cir. 2019) (rulemaking authorities "must provide sufficient factual detail and rationale for the rule to permit interested parties to comment meaningfully").

I. FINRA Ignores the Benefits of Investor Access to the Full Range of Investment Products through Self-Directed Platforms.

The growth in self-directed investing allows retail investors access to the full range of investment products previously accessible only to financial professionals. This opens the door to enormous benefits for investors.

First, Investor Access allows investors to achieve higher returns by eliminating the fees, often quite large, charged by investment managers and advisors.

Second, Investor Access allows investors to take charge of their own financial futures. Investors who want to make their own investment decisions, without intermediation or involvement by investment professionals, are free to do so. The ability to plan one's own financial future helps investors attain full financial independence, unbeholden to investment professionals and others whose values and aspirations may differ from their own. America's Founders understood the prime importance for a self-governing republic of citizens independent from the coercive influence of others—so often achieved through financial dominance—and therefore able to form and act on their own views of the world.[4] This freedom has become all the more important as so many investment managers and advisory firms have begun to divert client funds for the pursuit of their own political projects, in the form of ESG investing, which may contradict their fiduciary duties to clients.

Third, it allows investors to avoid the conflicts of interest that arise when investment professionals stand to profit more from some investment decisions than from others.

And fourth, it prompts investment advisors to create value by their prudent advice rather than profiting on their ability to give access to financial products unavailable to investors working alone. These benefits are all the more important because, as set forth below, they are exactly those that Congress sought in enacting the Exchange Act.

FINRA's Notice, however, does not discuss these benefits. FINRA treats the growth of self-directed platforms and the access they provide to products previously accessible only by investment professionals as solely a threat. The Notice does not mention the benefits of retail investor access through self-directed platforms *at all*, aside from a single cursory sentence at the beginning.[5] This silence is deafening when compared to the several pages of concern about the potential harms of investor access.[6]

It is irrational to act solely on the basis of the harms that Investor Access provides while ignoring its many benefits. Any regulation addressing Investor Access to the full range of

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[4] *See, e.g.*, Gordon S. Wood, *The Radicalism of the American Revolution* 106 (Alfred A. Knopf Inc., 1991).
[5] Notice 1.
[6] Notice 1-6.

investment options through self-directed platforms must take into account all factors bearing on this issue—including harms *and* benefits.[7] It is irrational to look at only one side of the ledger,[8] and any final rule that continues to do so will be arbitrary and capricious.

II. FINRA, in the Notice, Acts Contrary to the Goals of Industry Regulation.

FINRA's approach would be irrational coming from any agency, but most of all from an organization directed by law to pursue the purposes of the Securities Exchange Acts, for these Acts command the SEC to pursue efficiency, competition, and capital formation.[9]

It is clear that FINRA must likewise pursue these goals in its rules, for Congress instructed the SEC to consider them "in the review of a rule of a self-regulatory organization"[10] such as FINRA. Because FINRA disregards the many benefits of Investor Access through self-directed platforms, it is in no position to form views (and its Notice in fact does not form views) as to whether barring Investor Access to certain products would promote or diminish efficiency, competition, and capital formation.

Moreover, it is facially implausible that barring trading platforms from offering access to products that investment professionals may trade promotes competition or efficiency. Because FINRA does not ask about the benefits of Investor Access, it will continue to be unable to assess this question, as it must do if its rule is to survive SEC scrutiny and comply with Congress's directive to consider efficiency, competition, and capital formation.

FINRA's decision to treat Investor Access as an unalloyed threat infects the Notice with the taint of prejudgment and renders it ineffective at soliciting the comments FINRA would need to prepare a reasonable rule. FINRA makes no secret of its view that Investor Access poses only a threat. Additionally, among its thirty-four questions and sub-questions seeking all manner of information about ways to address the harm that it believes stems from Investor Access, *not one* asks about the benefits of Investor Access and how to enhance them.[11]

The public will take the none-too-subtle hint, and those who have information about the benefits of Investor Access or ideas for preserving that access and making it more effective will not comment, because they will not see the point.[12] FINRA therefore will not receive the

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[7] *E.g.*, *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).
[8] *See, e.g.*, *Michigan v. EPA*, 576 U.S. 743 (2015).
[9] Exchange Act § 3(f).
[10] *Id.*
[11] Indeed, there is only a single word among these questions to suggest that it is even possible to regulate investor access too stringently. *See* Notice 14 ("Would the aforementioned obligations unduly or appropriately restrict investor access to complex products?").
[12] *See, e.g.*, *Nat'l Tour Brokers Ass'n v. United States*, 591 F.2d 896, 902 (D.C. Cir. 1978) (public is unlikely to comment when it believes a rulemaking's outcome is a "*fait accompli*").

information it needs to offer solutions that reasonably take into account the good that Investor Access does as well as any harm.

The central issue in any rulemaking arising out of the Notice will be precisely the one FINRA ignores: what benefits does investor access to complex products provide and how do those benefits relate to any costs or risks it creates? The Notice indicates that FINRA has already made up its mind on this core question. And courts have long made clear that an agency's "unalterably closed mind"[13] on the core question of a rulemaking renders the rule unlawful.

To dispel the taint of prejudgment and obtain the information it needs to offer a reasonable regulation, FINRA must withdraw the current Notice and (if FINRA mistakenly chooses to proceed with this rulemaking) replace it with one that makes clear: 1) FINRA's appreciation of the many benefits of Investor Access that self-directed platforms provide and that seeks information about those benefits and ways to further promote them, as well as 2) an appraisal, more realistic than the current Notice's alarmism, of any risks that such access creates. FINRA's questions should include the following:

- Why do retail investors invest in complex products? How do these products assist them to achieve their financial goals?
- Why do retail investors choose to transact in complex products directly rather than through investment professionals?
- What particular complex products do retail investors transact in directly, and in what numbers?
- Do retail investors understand the details about their complex products that bear on risk and return?
- What is the typical level of financial knowledge and experience of retail investors who transact significantly in particular complex products?
- What are the mean and average values that retail investors invest in particular classes of complex products?
- Are there instances in which retail investors have imprudently transacted in complex products and suffered financial harm in consequence? If so, how often has that happened, and what is the magnitude of loss suffered? How does that loss compare to the loss suffered from imprudent recommendations by investment professionals?
- If retail investors were barred from transacting in products they prefer, would they cease investing in those products or retain an investment professional to transact for them?

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[13] *C & W Fish Co., Inc. v. Fox*, 931 F.2d 1556, 1565 (D.C. Cir. 1991).

III. In the Notice, FINRA Acts Contrary to Its Statutory Mission by Engaging in Protectionism for Investment Professionals and Paternalism for Investors.

FINRA is a creature of statute, bound to pursue the Exchange Act's objectives of promoting agency among investors and responsibility among investment professionals. FINRA exists pursuant to authorization by the SEC for the purpose of furthering the objectives of the Exchange Act.[14] One of Congress's main purposes in the Exchange Act was to give investors agency over their own investments. That is why the Act has little to say about substantive requirements for securities—it does not prescribe levels of risk or return, for instance—but instead creates a regime of *disclosure*, so that investors can make their own decisions.[15] Of course, such disclosures are pointless if investors cannot put them to good use; the central premise of the Exchange Act, then, is that investors can and must be trusted to make investment choices for themselves.

As far as investment professionals are concerned, Congress sought to make them faithful servants of investors. One of the main justifications for the Exchange Act was Congress's conclusion that hitherto brokers and dealers had been able to engage in sharp practice at the expense of the investors they served.[16] In the Exchange Act, Congress enacted provisions to make investment professionals accountable to their investors and to protect investors against the wiles of unscrupulous professionals.[17]

But in the Notice, FINRA gets it exactly wrong. In the first place, the Notice's policy would erect a protectionist barrier that would benefit investment professionals at the expense of the investors they are meant to serve. This is evident from the face of the Notice, which is full of proposals for limiting investor access and eager for more.

Most shockingly, the Notice suggests requiring FINRA members to categorically ban retail investors from accessing complex products.[18] Under the Notice's approach, investors could obtain these products *only* through investment professionals. The Notice also suggests permitting retail investors to transact in complex products only after receiving permission from investment professionals—which might be afforded only on the professionals' say-so[19] and which the

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[14] *See, e.g.*, *Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc.*, 72 Fed. Reg. 42169, 42182 (July 26, 2007).

[15] *Basic Inc. v. Levinson*, 485 U.S. 224, 230 (1988).

[16] *See, e.g.*, *Stock Exchange Practices: Report of the Committee on Banking and Currency* (June 16, 1934).

[17] *See, e.g.*, Exchange Act § 15(c)(6).

[18] Notice 14 (inquiring whether FINRA should "[r]equire members to make a reasonable assessment of whether a product is 'complex' before allowing a retail customer to transact in the product").

[19] Notice 13 (inquiring about "[e]nhanced account approval processes before an account may trade in complex products"); *id.* at 15 (inquiring whether FINRA should require that approval of investors for

professionals might deny to investors because they are not "high-net worth" or because they do not fall within "other categories of customers."[20] The Notice contains many other suggestions that would raise barriers, large or small, to investor access,[21] and asks investment professionals for more ideas of how to restrict access.[22]

Such a policy would limit investor options while allowing investment professionals to charge higher fees that reflect, in addition to the value of their advice, the value of mere *access* to additional financial products. In any other context, a published plan by a group of professionals forbidding its members to assist the public in a way that would diminish the need for their own services would rightly be the subject of public wrath and federal law enforcement. While the Exchange Act's sanctioning of securities self-regulatory organizations means that the federal antitrust laws do not apply to them in their full vigor, the Exchange Act should not be read to foreclose antitrust liability when a self-regulatory organization adopts horizontal restraints of trade that drive up prices for investors while limiting their options without advancing any of the Exchange Act's goals.

The Notice would also promote a paternalistic vision of investor protection that Congress has squarely rejected. In the first place, let us be clear: this Notice is about protecting investors from themselves. While the Notice glancingly asserts that retail investor purchases of complex products could create systemic risk,[23] it cites no evidence that retail investors buy any complex products in sufficient quantities to roil the deep waters of the U.S. financial system. FINRA's fear is just that retail investors are too muddled to understand complex products but too reckless to resist their sirens' song.

But for the reasons given above, this sort of paternalism has no place under the Exchange Act. The Act's central premise is trust in investors to make their own decisions, but the Notice would encourage and even require professionals to limit investors' ability to do just that.[24]

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access to complex products turn on "objective criteria" rather than just the investors' own self-assessments).

[20] Notice 13.

[21] Notice 13-15.

[22] Notice 13.

[23] Notice 5.

[24] That FINRA may in the past have departed from this principle in the context of options trading does not warrant another, and much more troubling, departure here. FINRA's proposed approach would apply not just to a single, definite class of products, but to a vaguely defined superclass that may include hundreds of types of products. The breadth and vagueness of FINRA's proposed approach make it a far more aggressive and impactful measure than FINRA's existing options regulations. And in any event, if the arguments we have advanced are in tension with FINRA's options regulations, that is a good reason to change those mistaken regulations rather than to double down on FINRA's earlier mistake. We further note that, while our arguments have focused on complex products broadly, many of those arguments constitute good reasons against the Notice's suggested revisions to FINRA's rules on options trading.

IV. The Notice's Approach, If Incorporated in a Final Rule, Will Be Arbitrary and Capricious under the APA.

A. The Notice's Failure to Define Its Central Term Fatally Undermines Its Approach.

As the Notice concedes, FINRA has never clearly marked out complex from simple products; instead, it has merely listed particular examples of complex products while insisting that its list is non-exclusive. This lack of clarity leaves the Notice both substantively and procedurally deficient, as it deprives us of the ability to adequately comment. The Notice continues to defend that approach.[25]

But this approach leaves both investment professionals and investors themselves in the dark about whether particular products would be covered by whatever restrictions FINRA eventually adopts. Investors may build their financial strategies around products that they may one day discover they are no longer allowed to access. At the same time, the uncertainty of the line between complexity and simplicity will pressure self-driven platforms to err on the side of caution, curtailing the ability of retail investors to trade even instruments that FINRA may one day conclude are not complex after all.

The closest FINRA comes to offering a meaningful line between complex and simple products is that "a complex product [is] a product with features that may make it difficult for a retail investor to understand the essential characteristics of the product and its risks."[26] But this pronouncement leaves open too many questions to be useful.

Despite FINRA's apparent view, retail investors are not a monolith: they vary widely in knowledge, experience, and interests. But FINRA does not say what sort of retail investor professionals must have in mind when they evaluate whether a product is complex. An investor who is likely to be interested in the particular product? An investor who is likely to consider significant use of the product in his or her portfolio? An investor of average or minimal financial sophistication? For that matter, how many investors must be likely to find a product confusing? Is it enough for *any* retail investor to be confused?

Nor does FINRA tell us what are the "essential characteristics of the product." The one thing clear is that "essential characteristics" include considerably more than the structure of the product and its underlying assets, for the Notice suggests that the fact that "a wholly-owned offshore subsidiary"[27] is involved in a particular product is enough to make it complex. It also appears that the involvement of certain asset classes, such as cryptocurrency, is *ipso facto* enough to make a product complex, even if the asset class in question is transacted by tens of millions of people around the world.[28] FINRA does not explain *why* these features make a

[25] Notice 3.
[26] Notice 3.
[27] Notice 4.
[28] Notice 4.

product complex; nor does it tell us what other features might be enough. Investors and professionals would therefore be required to guess what features are significant for FINRA's complexity analysis.

How are investment professionals to ascertain whether retail investors would find a product's "essential characteristics" difficult to understand? It is clear that the ordinary method of discovering whether someone understands something—asking him or her—is not enough for FINRA.[29] But what is enough? Intuition? Surveys?

FINRA continues to endorse this confusing approach "to avoid a static definition that may not address the evolution of financial products and technology."[30] But agency flexibility is not the only good at stake in crafting a regulatory definition; regulatory certainty matters as much or more. That is particularly the case where new "products and technology" are rapidly "evol[ving]," as FINRA admits is the case here.[31]

FINRA is obligated to acknowledge the costs of its choice not to define the central term in its regulatory approach, to seek to understand those costs, and to give them careful consideration rather than instinctively opting for flexibility that preserves its own power. Anything less would be arbitrary and capricious.

FINRA's choice not to define its key term is particularly perverse because the assumption of the Notice is that retail investors cannot understand complex products. However, under FINRA's approach, retail investors who wish to know which products they will be permitted to access must understand the "essential characteristics" of those products—which FINRA asserts they cannot understand—*and also* how FINRA will evaluate these characteristics under the Notice's vague framework. The Notice thus presumes just the sort of sophistication the absence of which is the Notice's rationale. That FINRA failed to appreciate the irony of its position is due to the impermissible paternalism of its approach. Retail investors have a right to understand the regulatory regime under which they invest so that they can exercise full agency in crafting investment strategies to secure their financial futures.

For these reasons, the Notice offers an approach "so vague that men of common intelligence must necessarily guess at its meaning."[32] The Notice demands guesswork not at the margins, but with respect to the key term on which its application entirely depends. Our Constitution forbids leaving the public in that plight.[33]

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[29] *See, e.g.*, Notice 15 (suggesting inadequacy of investor self-assessments).
[30] Notice 3.
[31] Notice 3.
[32] *FCC v. Fox Television Stations, Inc.*, 567 U.S. 239, 253 (2012).
[33] *Id.*

B. The Notice Fails to State a Problem.

Despite its certitude that Investor Access to the full range of financial products is dangerous, the Notice does not cite a single real-world example of harm from this access. Rather, it cites data showing that trading of arguably complex products is on the rise[34]—but not that that rise has adversely impacted retail investors.

Indeed, the only real-world problems the Notice cites are instances of mistakes and misconduct *by investment professionals*.[35] But rather than concluding that, in light of such mistakes and malfeasance, it is imprudent to leave investors in the power of investment professionals, the Notice proposes to double down, imposing restrictions that would render investors further dependent on the skill and good faith of professionals.

Rather than documenting real-world harms arising from investor access, FINRA infers a problem from the existence of certain products that it asserts *might* confuse retail investors and from the fact that some retail investors may trade these products.[36] But that is a problem only if retail investors imprudently rely on their own judgment where they are incompetent to judge—and FINRA has cited not a single data point to suggest that retail investors in fact rush in where angels fear to tread. For all FINRA can show, the only retail investors who trade complex products are those who understand them.

FINRA has thus failed to show that retail investors' access to the full range of investment products creates a problem—and a regulation aiming at a problem is "highly capricious if that problem does not exist."[37]

V. FINRA Disregards the Critical Role of the States in Educating Their Residents about Financial Matters.

If FINRA's unsupported assertions are accurate that undereducated investors are in fact transacting in complex products and suffering consequent harm, a better way to address that problem would be to educate the investors, for doing so would preserve the important benefits of investor access while eliminating investor harm.

The states have a long tradition of educating their residents about financial matters. As of 2018, all but five states had financial literacy standards built into their educational requirements.[38] And states have undertaken a vast array of initiatives to educate the public about

[34] Notice 12.
[35] Notice 5.
[36] Notice 12.
[37] *Alltel Corp. v. FCC*, 838 F.2d 551, 561 (D.C. Cir. 1988).
[38] *See* Kasman, Heuberger, & Hammond, *Are states providing adequate financial literacy education?*, Brookings (Oct. 3, 2018), https://www.brookings.edu/research/are-states-providing-adequate-financial-literacy-education/.

financial matters. For instance:

- Utah established the Council on Financial and Economic Education "to ensure improved financial and economic education in Utah through the collaboration of private and public entities that engage in teaching financial principles."[39]

- Tennessee has created the Financial Literacy Commission, which has created the Financial Empowerment Resource Library to help adults become more financially savvy.[40]

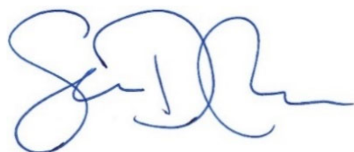
There are also many private financial literacy initiatives, such as the Jump$tart Coalition for Personal Financial Literacy, which "consists of more than 100 national organizations and a network of 51 … state coalitions that share a commitment to advancing youth financial literacy."[41]

The Notice fails to consider whether states (or private entities) are better situated to remedy the asserted problem through their longstanding and effective educational efforts than FINRA could through top-down controls that limit investor access. As the SEC has discovered to its cost, failure to consider whether federal regulation is needed in light of effective state efforts renders a regulation arbitrary and capricious under the APA.[42]

Conclusion

For the reasons set forth herein, FINRA should withdraw its Notice and Request for Comment. If FINRA believes the matter should continue to be addressed, it should start with the basic and fundamental work of (1) defining a "complex product," (2) researching whether there is a problem involving complex products that needs to be addressed, and (3) asking whether the remedy to any problem should originate with FINRA at all.

Respectfully submitted,



Sean D. Reyes
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[39] Utah, *Financial Education*, https://treasurer.utah.gov/utahfe/.
[40] Tennessee, *Education: Worth the Investment*, https://treasury.tn.gov/Financial-Education/Financial-Literacy-Commission/Education-Worth-the-Investment.
[41] *About Us*, Jump$tart, https://www.jumpstart.org/who-we-are/about/.
[42] *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 178-79 (D.C. Cir. 2010).

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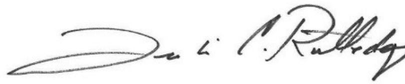
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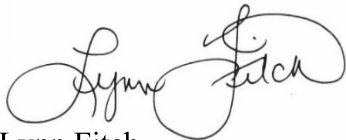
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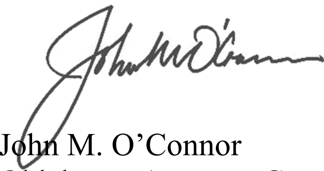
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